

Reporting financial performance

OVERVIEW

We will in this chapter deal with a number of topics that might at first sight appear to be separate and discrete but which are in fact linked. The chapter falls into three parts.

The first part, A, is concerned with how the informational content of a set of financial statements can be improved by rearranging the ways in which the figures are presented. Hence we start with an examination of FRS 3 *Reporting Financial Performance*, a standard that deals with how the financial statements should distinguish between continuing and discontinued operations but which also introduced the distinction between those items that should appear in the profit and loss account and those that should appear in the statement of total recognised gains and losses (STRGL).

A related theme is that of segmental reporting, which is concerned with the extent to which figures in the financial statements should be disaggregated in terms of such factors as different types of products and different markets. We will look at the legal and stock market requirements as well as the content of SSAP 25 *Segmental Reporting*.

Part B of the chapter is concerned with the way in which information that is contained within the financial statements is modified or expanded for a number of reasons. The first relates to time, and here we discuss how happenings that have occurred after the year end may affect the financial statements. In other words we will discuss the treatment of post-balance-sheet events. The second concerns the relationship between the price of a share and earnings and the consequent need to calculate and report earnings per share on a consistent basis. The third matter that we discuss in this section, which impacts on the notes to the financial statements rather than the amounts included therein, is concerned with the transactions that the entity undertakes with so called related parties.

In the final part of the chapter we discuss the controversial subject of share-based payments and, in particular, the vexed question of employee share options. We describe the method of accounting for share-based payments that is being advocated by international standard setters and discuss the reactions, both positive and negative, that those proposals have evinced.

The various standards and exposure drafts covered in this chapter are:

- FRS 3 *Reporting Financial Performance* (1992)
- FRED 22 *Revision of FRS 3 'Reporting Financial Performance'* (2000)
- IAS 1 *Preparation of Financial Statements* (revised 1997)
- IAS 35 *Discontinuing Operations* (1998)
- SSAP 25 *Segmental Reporting* (1990)
- IAS 14 *Segment Reporting* (revised 1997)
- SSAP 17 *Accounting for Post Balance Sheet Events* (1980)
- IAS 10 *Events after the Balance Sheet Date* (revised 1999)
- FRED 27 *Events after the Balance Sheet Date* (2002)
- FRS 8 *Related Party Transactions* (1995)
- IAS 24 *Related Party Disclosures* (reformatted 1994)

- FRED 25 *Related Party Disclosures* (2002)
- FRS 14 *Earnings per Share* (1998)
- IAS 33 *Earnings per Share* (1997)
- FRED 26 *Earnings per Share* (2002)
- FRED 31 *Share-based Payments* (2002)

The number of exposure drafts in the list indicates the extent to which a number of the aspects covered in the chapter are, at the time of writing, part of the convergence programme.

Part A Reconfiguring the financial statements

Reporting financial performance

Financial statements report on past performance but they are also used as an aid in the prediction of future performance. Prediction is usually heavily dependent on an extrapolation of the past. Suppose, to take a simplistic example, one wants to predict future profits in order to place a value on a business. The obvious starting point is the current level of profit and recent rates of growth (or decline). Suppose the current profit is £3.0 million and growth has been on average 3 per cent per year over the recent past, the predictor would start by thinking whether the growth rate is likely to continue into the future or whether a different rate should be used. But in performing this simple extrapolation the predictor will need to consider the extent to which the future will differ from the past. In order to help achieve this there are two main ways in which the financial statements can be reconfigured.

One is to separate gains and losses between those that can be regarded as normal consequences of the course of business, and hence might reasonably be extrapolated, and those which are odd or unusual and which are not expected to recur on a regular basis. The second device is relevant only when an entity stops engaging in certain of its activities. If this occurs the financial statements should make a clear distinction between the results that derive from the part of the business that will be continued and that part that is being discontinued.

The desire to show separately what might be termed continuing or normal operating items and non-recurrent elements of the business resulted, in the past, in a loss of comparability in that different companies dealt with the issue in different ways. From time to time, abuses occurred because companies attempted to play down the effect of bad decisions by treating the resulting losses as a non-recurring item. New standards have been introduced that not merely seek to prevent such abuses but more positively attempt to ensure that the financial statements provide users with more relevant and helpful information. The approach that has now been adopted is well described in the *Statement of Principles*:

The ability to use information in financial statements to make assessments is enhanced by the way in which it is presented. For example, the predictive value of information provided by the financial performance statement is enhanced if unusual or infrequent items of gains or losses are disclosed and if information is provided that helps users to assess the likely incidence of similarly unusual or infrequent gains or losses in the future. In the same way, presentations that help users to understand the recurring/non-recurring nature of the various gains and losses also improve the predictive value of the performance statement.¹

¹ *Statement of Principles*, Para. 3.4.

The ASC first dealt with this topic in April 1974 through the issue of SSAP 6 *Extraordinary items and prior year adjustments*, which was reissued in a revised form in August 1986. SSAP 6 was replaced in 1992 by the more wide-ranging FRS 3 *Reporting financial performance*. The subject is now under review by the ASB and, as part of this work, the Board published a discussion paper *Reporting financial performance: Proposals for change* in 1999, followed by an exposure draft FRED 22 *Revision of FRS 3 'Reporting financial performance'* in December 2000.

SSAP 6 Extraordinary Items and Prior Year Adjustments

Since FRS 3 is in many respects a development of SSAP 6 it will be useful briefly to summarise SSAP 6 before dealing in more detail with the provisions of the FRS.

The problem that gave rise to the issue of SSAP 6 was the variety of practice concerning the treatment of income and expenditure that was regarded as being 'non-recurring'. Two extreme positions could be identified. At one extreme all items were passed through the profit and loss account, while at the other extreme any items which could be argued as not relating to the normal activities of the business (non-recurring items) were charged or credited direct to reserves or adjusted against the opening balance of retained profits. The latter method is known as 'reserve accounting'.² In practice, most companies adopted a position between the two extremes.

The argument in favour of reserve accounting was that a profit or loss based only on the 'normal activities' of the business gave a fairer indication of the business's maintainable profit. It was suggested that such a profit figure would provide the more useful basis for estimating future profits than the profit resulting from a profit and loss account that included all items irrespective of their nature.

The view of the ASC, as evidenced by the provisions of SSAP 6, was that all revenue items should pass through the profit and loss account. The reasons for this view were as follows:

- (a) The inclusion and disclosure of the non-recurring items enables the profit and loss account for the year to give a better view of a company's profitability and progress.
- (b) The exclusion of non-recurring items requires the exercise of subjective judgement and may lead to variation in the treatment of similar items and hence to a loss of comparability between the accounts of different companies.
- (c) The exclusion of non-recurring items could result in their being overlooked in any review of results over a series of years. Thus, while the nature of the items will, by definition, change, many businesses, especially larger ones, will often have items that are 'non-recurrent' and continually to exclude them from the profit and loss account would result in a distorted view of profit being shown.

The wholly sensible view of the ASC was that the legitimate advantages of reserve accounting could be obtained, without the drawbacks listed above, if adequate disclosure is provided in accounts. In essence, SSAP 6 required that all profits and losses recognised in the year should be shown in the profit and loss account. There were, however, two exceptions – prior year adjustments and certain items that, either by law or under the provisions of an accounting standard, were specifically permitted or required to be taken directly to reserves.

While the standard did in general reject the use of reserve accounting, it did accept the notion that it is possible, and helpful to users, to distinguish between the results of ordinary

² The two approaches are also often described, particularly in the USA, as 'all inclusive income' and 'current income', respectively.

activities of the business and *extraordinary* (non-recurring) profits and losses. Thus the standard prescribed, if there were any extraordinary items, that the following elements should be included in the profit and loss account:

- post-tax profit before extraordinary items;
- extraordinary items (less taxation attributable thereto);
- post-tax profit after extraordinary items.

In addition, items of an abnormal size and incidence but which may be regarded as deriving from the ordinary activities of the business, *exceptional items*, should be disclosed but included in the derivation of the profit before extraordinary items.

The above provisions of SSAP 6 were incorporated into statute law by the Companies Act 1985 but the Act does not attempt to define the various terms, a task left to the standard setters.

FRS 3 Reporting Financial Performance

FRS 3 is based on the same principles as SSAP 6 but includes three important changes.

- (a) It provides more precise and more useful definitions of the key terms and in particular limits drastically the circumstances under which an item can be classed as extraordinary.
- (b) It puts greater emphasis on reporting the effects of discontinued operations. This has led to a change in the format of the profit and loss accounts of enterprises that have discontinued part of their operations during an accounting period.
- (c) It requires the inclusion of three additional elements in the financial statements:
 - (i) a statement of total recognised gains and losses, including the profit or loss for the period together with all other movements on reserves reflecting recognised gains and losses attributable to shareholders;
 - (ii) a reconciliation of movements in shareholders' funds bringing together the performance of the period, as shown in the statement of recognised gains and losses, and all other changes in shareholders' funds in the period, including capital contributed by or repaid to shareholders;
 - (iii) a note, which would be of relevance to companies which had revalued assets at some stage in their history, reconciling the profit or loss disclosed in the accounts with that figure which would have been disclosed had the company not revalued assets, i.e. the profit based on the strict application of the unmodified historical cost convention.

We will deal with each of these later in the chapter.

Exceptional and extraordinary items

The key definitions relating to ordinary activities and exceptional and extraordinary items provided in FRS 3 are:

Ordinary activities

Any activities which are undertaken by a reporting entity as part of its business and such related activities in which the reporting entity engages in furtherance of, incidental to, or arising from, these activities. Ordinary activities include the effects on the reporting entity of any event in the various environments in which it operates, including the political, regulatory, economic and geographical environments, irrespective of the frequency or unusual nature of the events. (Para. 2)

Exceptional items

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. (Para. 5)

Extraordinary items

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. (Para. 6)

The last sentence of the definition of 'Extraordinary items', which has to be read a few times to be understood, simply means that an item does not become extraordinary simply because it is recognised in the profit and loss account in a period following the one in which it occurred.

The definition of ordinary activities contained in FRS 3 is much wider than the corresponding definition in SSAP 6. As a consequence the definition of extraordinary items provided in FRS 3 is very much more restricted than the SSAP 6 version, with the result that, in the words of the ASB, extraordinary items are now likely to be '*extremely rare*' (Para. 48). Because of this, FRS 3, unlike SSAP 6, does not provide examples of extraordinary items. An illustration of the extent of the change is one of the examples provided in SSAP 6, the expropriation of assets, which is now regarded as part of the ordinary activities of the business because of the revised definition of that term. Another of the major examples of extraordinary items provided in SSAP 6 is the consequence of the discontinuity of a separate segment of the business that, as we will explain below, is now treated in an entirely different way.

The question of whether an item should be regarded as exceptional is essentially a matter of judgement related to whether knowledge of the item will provide the users of the financial statement with a clearer picture of the performance of the company. By definition, exceptional items must be material but thereafter the recognition of such items depends on size or incidence. The meaning of 'incidence' in this context is not clear, nor is it explained in FRS 3, but it presumably relates to items which lie somewhere between material and large but which will nonetheless have some significance in assessing the maintainable profits of the enterprise. Thus, for example, the profit or loss on the sale or termination of operations of a type which do not satisfy the rather tight conditions for recognition as discontinued operations (see p. 283) may not be large but may yet be significant in judging the future profitability of the business, perhaps because had the operation not been terminated large losses would have been sustained in the future.

Prior-period adjustments

These are defined as:

Material adjustments applicable to prior periods arising from changes in accounting policies or from the correction of fundamental errors. They do not include normal recurring adjustments or corrections of accounting estimates made in prior periods. (Para. 7)

In some ways it is unfortunate that the ASB did not use a different name for this type of adjustment because, as is pointed out in FRS 3 (Para. 60), the vast majority of items relating to prior periods arise from the corrections and adjustments which are the natural result of estimates inherent in periodic financial reporting and are therefore not covered by the defin-

ition of prior period adjustment; perhaps a title such as Fundamental Prior Period Adjustment would have been preferable.

The normal run of adjustments relating to prior periods are dealt with in the profit and loss account of the period in which they are identified. They are not exceptional or extraordinary merely because they relate to a prior period, but if their effect is material then they would be disclosed as an exceptional item or, in very rare cases, an extraordinary item.

The importance of consistency as a fundamental accounting concept is emphasised and it is stated that a change in accounting policy should therefore be made only when it can be justified that the new policy gives a fairer presentation of the financial position of the reporting company. An adaptation or modification of an accounting basis caused by transactions or events that are clearly different in substance from those which occurred in the past does not give rise to a change of accounting policy and hence does not result in a prior period adjustment (Para. 62).

The second element in the definition of prior period adjustments is the correction of fundamental errors. To be treated as prior period adjustments such errors would need to be of such significance that the financial statements that contained them could not show a true and fair view.

Prior-period adjustments and disclosure requirements

Prior period adjustments should be accounted for by adjusting the opening balance of reserves for the cumulative effect of the adjustments and by restating the comparative figures for the preceding period. In addition, the cumulative effect of the adjustment should be noted at the foot of the statement of total recognised gains and losses of the current period whilst the effect of the prior period adjustments on the results for the preceding period should be disclosed where practicable. (Para. 29)

Reflecting the results of discontinued operations

A company cannot maintain the profits of operations which it no longer carries out, and thus it seems reasonable to ensure that financial statements discriminate clearly between the results which have been achieved by that part of the enterprise which will continue, and the results achieved or losses sustained by those parts of the organisation which had been closed or sold during the course of the year.

In order to achieve this, FRS 3 calls for what is, in effect, two profit and loss accounts; one covering those operations that will continue in the future, which includes acquisitions made during the year, and one dealing with any part of the enterprise that was sold or terminated during the course of the year.

The way in which the information is disclosed, whether by way of note or on the face of the profit and loss account, is to a large measure left to the accountant, guided by two examples provided in the Appendix to FRS 3. The discretion is not unlimited, however, because as a minimum there should be shown on the face of the profit and loss account analyses of turnover and operating profit as between discontinued and continuing operations.

Adjustments are also required in the comparative figures because only the results of those operations which are regarded as continuing at the year end should be included in the preceding year's figures for continuing operations. This is an important measure that helps the users of the financial statements to gain a clearer picture of the progress of the company.

One of the two illustrations provided in the standard is reproduced in Table 11.1.

Table 11.1 Illustration of profit and loss account format under FRS 3

	<i>Continuing operations</i>		<i>Discontinued</i>	<i>Total</i>	<i>Total</i>
	<i>Acquisitions</i>		<i>operations</i>		
	1993	1993	1993	1993	1992 as restated
	£ million	£ million	£ million	£ million	£ million
Turnover	550	50	175	775	690
Cost of sales	(415)	(40)	(165)	(620)	(555)
Gross profit	135	10	10	155	135
Net operating expenses	(85)	(4)	(25)	(114)	(83)
Less 1992 provision			10	10	
Operating profit	50	6	(5)	51	52
Profit on sale of properties	9			9	6
Provision for loss on operations to be discontinued					(30)
Loss on disposal of discontinued operations			(17)	(17)	
Less 1992 provision			20	20	
Profit on ordinary activities before interest	59	6	(2)	63	28
Interest payable				(18)	(15)
Profit on ordinary activities before taxation				45	13
Tax on profit on ordinary activities				(14)	(4)
Profit on ordinary activities after taxation				31	9
Minority interests				(2)	(2)
[Profit before extraordinary items]				29	7
[Extraordinary items] (included only to show positioning)				—	—
Profit for the financial year				29	7
Dividends				(8)	(1)
Retained profit for the financial year				21	6
				1993	1992
Earnings per share				39p	10p
Adjustments [to be itemised and an adequate description to be given]				<i>x</i> p	<i>x</i> p
Adjusted earnings per share				<i>y</i> p	<i>y</i> p
[Reason for calculating the adjusted earnings per share to be given.]					

Table 11.1 Continued

<i>Required Note:</i>	1993			1992 (as restated)		
	<i>Continuing</i>	<i>Dis-</i> <i>continued</i>	<i>Total</i>	<i>Continuing</i>	<i>Dis-</i> <i>continued</i>	<i>Total</i>
	<i>£ million</i>	<i>£ million</i>	<i>£ million</i>	<i>£ million</i>	<i>£ million</i>	<i>£ million</i>
Turnover				500	190	690
Cost of sales				385	170	555
Net operating expenses						
Distribution costs	56	13	69	46	5	51
Administrative expenses	41	12	53	34	3	37
Other operating income	(8)	0	(8)	(5)	0	(5)
	89	25	114	75	8	83
Operating profit				40	12	52

The total figure of net operating expenses for continuing operations in 1993 includes £4 million in respect of acquisitions (namely distribution costs, £3 million, administrative expenses, £3 million and other operating income, £2 million).

What constitutes discontinuity?

FRS 3 defines discontinued operations in the following way:

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. (Para. 4)

The objective of FRS 3 is clearly laudable in attempting to help users extrapolate past results into the future but the drawing of a distinction between continuing and discontinued operations is clearly open to abuse. Most businesses continually modify their range of operations; some product lines or activities will be dropped in the course of the year and these will usually be those that are less successful. Hence, if there were no limits on what could be designated as discontinued operations a business could make the 'continuing operations' part of the profit and loss account look very healthy by shunting the results of all abandoned product lines or activities into the discontinued operations section.

In order to prevent, or rather minimise, the opportunity for whitewashing the profit and loss account in this way, the ASB has laid down a rigorous definition of what constitutes discontinuity. As can be seen above there are four tests, all of which must be satisfied. The first two tests are fairly clear; the discontinuity must be completed either in the year or within three months of the balance sheet date, or even earlier if the date of approval of the financial statements is within that three-month period. Also, the termination must be permanent and not a temporary withdrawal from a particular market. Condition (d) is also reasonably straightforward. It requires that the 'operation' must have constituted a distinct chunk of the business in operational, physical and financial terms. Further elaboration of that point is provided in Para. 44 of the standard. To satisfy the condition, the operation must have been a revenue and cost centre to which all material items of revenue and costs were specifically assigned or, to put it another way, one where only a very small reliance had to be placed on the allocation of joint costs and revenues.

Condition (c) of the definition requires that the sale or termination must have had a material effect on the nature and focus of the enterprise but this does seem to beg the question of what is meant by the focus of the reporting entity's operations. The ASB goes some way to answering the question in that it states, 'including the aspects of both quality and location' (Para. 42). The nature and focus of the reporting entity's operations refers to the position of its products or services in their markets.

An example is given of a hotel company that sells its existing chains of hotels that operate at the cheaper end of the market and then buys a chain of luxury hotels. This, it is stated, can be regarded as 'changing its focus' and hence the sale could be treated as a discontinued operation even though the company stays in the hotel business. Similarly, a sale of all its hotels in one country might also be regarded as a discontinuity, even if, as a result, hotels are purchased in another country.

Two points need to be made about this example. The first relates to the use of the term 'chain' which implies that the hotels were operated as an identifiable group that was sold in its entirety. The sale of only the cheap hotels in a chain which were operated under the same name as the remaining luxury hotels and which shared common services would probably not satisfy the 'separateness' tests specified in condition (d).

The second point is that condition (c) requires that for the sale to be treated as a discontinuity it must represent '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' (Para. 4c).

There is, perhaps, an ambiguity here. Can the sale be treated as a discontinuity if the material reduction in operating facilities in one market is replaced by an equivalent increase in another market? The example provided in Para. 42 suggests that it can but this is not clear from the wording of Condition (c) of the definition that places stress on the 'material reduction in operating facilities'. In reviewing the standard, the ASB might consider revising its definition to make it clear that a change in the style of operation that does not materially affect the totality of operating facilities can still be treated as a discontinuity for the purposes of the standard.

Acquisitions

In estimating future results it is necessary to take account of the effect of any acquisitions made during the year. Normally (the 'exception' being the use of the merger method of consolidation, see Chapter 13, only post-acquisition results will be included in the profit and loss account, but the user of the accounts will want to know the full year results of the company acquired. The Companies Act 1985 (Schedule 4A, Para. 13) requires that information

relating to the profit or loss of any group or company acquired from the start of the financial year of the acquired undertaking to its date of acquisition should be shown in a note to the financial statement. The note must also state the date of the start of the financial year of the acquired undertaking and provide information relating to the previous accounting period.

The additional requirements of FRS 3 are that there should be shown:

- (a) on the face of the profit and loss account: analyses between continuing operations, acquisitions (as a component of continuing operations) and discontinued operations of turnover and operating profit;
- (b) on the face of the profit and loss account or in the notes: a similar threefold analysis of each of the statutory profit and loss format items between turnover and operating profit.

Acquisitions are shown as part of continuing operations except when an operation is both acquired and discontinued in the course of the year; then it should be treated as discontinued.

If it is not possible to determine the post-acquisition results of the new operation, then either an indication of the contribution of the acquired operation to turnover and operating profit should be disclosed or, if that is not possible, an explanation should be provided of the reasons for the company's inability to provide the information.

What should be included in the results of discontinued operations?

If an operation is sold or terminated in a year, two elements of profit or loss arise. One is the trading profit or loss to the date of termination, the other is the profit or loss on the disposal of the assets constituting the operation. FRS 3 provides that both should be included in the determination of the profit or loss on ordinary activities before taxation, albeit separately identified. This is in contrast to the provisions of SSAP 6, whereby profits or losses on the sale of a business segment were treated as extraordinary items and hence shown after the derivation of profit or loss on ordinary activities.

One of the members of the ASB, Robert Bradfield, did not vote for the adoption of the standard and one of his reasons for this, explained in his dissenting view (published alongside the standard), was the inclusion of profits or losses on the disposal of operations in the figure for pre-tax profit. Bradfield believed that the standard placed undue emphasis on the pre-tax profit figure which may be misleading if it includes the profits or losses on disposal, especially as the tax effects, as allowed by FRS 3, are only shown in the notes. The view of the majority of the members of the ASB, expressed in the section of the standard entitled 'A Development of the Standard', is that the FRS 3 approach does not place emphasis on a single number because the admittedly complex presentation is based on an 'information set' approach that highlights a range of important components of performance. However, if a single measure of performance is to be used – for example in calculating earnings per share – then it should be based on its 'all-inclusive' concept which avoids the inconsistencies which were experienced in the application of SSAP 6.

Provision for future losses

There is a great temptation to say that if the company has to take its medicine then it should drink deeply of it. Thus if the company decides that it should either eliminate entirely or reduce extensively its loss-making operations in, say, the United States, the announcement will have an adverse effect on share prices and there would be less confidence in the company's future; a confidence which the company will want to restore as quickly as possible. One way of helping to restore confidence quickly may be to lump as much of the loss into the 'bad news' year as possible and to relieve future years of the burdens of those losses.

To provide for everything in sight, and possibly just a wee bit more, may well be prudent but it is likely to be exceedingly misleading.

Consider the following two series of numbers:

Year	Results (£ million)					Total
	1	2	3	4	5	
A	L10	L2	–	P2	P4	L6
B	L16	P1	P2	P3	P4	L6

(L = Loss, P = Profit)

To oversimplify, let us suppose that series A represents the ‘truth’ but B represents the results of the company if an excess provision of £6 million is made in the ‘bad news’ year, year 1. The ‘prudent’ approach under B suggests that the company is immediately restored to profit in year 2 and then makes steady growth, whereas in fact the ‘true’ position is that profit is not restored until year 4 but that the real rate of improvement is then higher than is shown by the prudent approach.

Now let us see how this matter is dealt with in FRS 3, remembering that in accordance with normal practice any permanent diminution in asset values should be recorded. The essential point of FRS 3, Para. 18, is that provisions should be made for the direct cost of sale or termination and any operating losses of the operation up to the future date of sale or termination (after in each case taking account of related profits), if and only if there exists a binding sale agreement or the company is demonstrably committed to the sale or termination because, for example, the action is covered by detailed formal plans from which the company cannot realistically withdraw.

The provision would be included as part of discontinued operations only if the related event qualifies as a discontinuity. Note that the conditions for discontinuity and the condition precedent for making a provision are different and that provisions can be made for operations that are for the purposes of FRS 3 treated as continuing.

When in the subsequent period the operation is actually closed, its results for that period should not be lumped together but shown under the statutory format headings, but there also needs to be full disclosure on the face of the profit and loss account showing the way in which the provisions made in prior years have been utilised, indicating how much has been used to cover operating losses and how much to cover the loss on sale or termination of the discontinued operation.

The treatment of provisions for future losses specified in FRS 3 is consistent with the position adopted by the ASB in FRS 12 *Provisions, Contingent Liabilities and Assets*.

Taxation

In deciding how taxation should be disclosed, the ASB had before it two main options. One was to relate the tax charge on the face of the profit and loss account to its basic elements – for example, continuing and discontinuing operations, and extraordinary and exceptional items – and to show the total tax charge by way of a note. The alternative was to show the total tax charge on the face of the accounts and provide the analysis in the notes. By and large, with the exception of extraordinary items, the ASB adopted the latter approach.

The disclosure provisions at Para. 23 are of both a general and a specific nature. The general elements of the standard are:

- (a) Any special circumstances that affect the overall tax charge or credit for the period, or that may affect those of the future periods, should be disclosed by way of a note to the profit and loss account and their individual effects quantified.
- (b) The effects of a fundamental change in the basis of taxation should be included in the tax charge or credit for the period and separately disclosed on the face of the profit and loss account.

In addition there are specific disclosure provisions relating to:

- (a) Profits or losses on the sale or termination of an operation.
- (b) Costs of fundamental reorganisation or restructuring.
- (c) Profits or losses on the disposal of fixed assets.

In each case relevant information should be provided in the notes showing their effect on the tax charge.

Taxation and extraordinary items

FRS 3 provides, in Para. 22, that the tax on extraordinary items should be shown separately as a part of the extraordinary profit or loss either on the face of the profit and loss account or in a note. Any subsequent adjustments to the tax on extraordinary profit or loss should also be shown as extraordinary items.

A dissenting view

We have already referred to the dissenting view of Robert Bradfield. One of the major elements of Bradfield's opposition to the provision of FRS 3 was his belief that users of accounts would not fully appreciate the taxation effect on the trading results attributable to shareholders (he made a similar point relating to minority interest). As an example, Bradfield quotes the case of an international group of companies where the pre-tax trading profits in a low-tax regime fell and those in a high-tax regime increased by an identical amount. Such a change would leave the shareholder materially worse off but this would be masked in FRS 3.

The point is a good one and needs further consideration. This needs to be conducted in the light of a broader consideration relating to the reaction of shareholders and other users of accounts to the far more complex structure of financial statements that have appeared as a result of FRS 3. A particular issue is the balance between the information disclosed in the primary financial statements and that in the notes to those statements.

Minority interests

In the case of consolidated financial statements the information disclosure requirements for minority interests are very similar to those for taxation. The effect of three specific items referred to above (the termination of an operation, the fundamental reorganisation of operations and the profit or loss on disposal of fixed assets) on minority interests should be noted. If there are any extraordinary items that affect minority interests then the extent of the extraordinary profit and loss attributable to minority shareholders should be shown separately as a part of the extraordinary item, either on the face of the profit and loss account or in a note.

The statement of total recognised gains and losses

We have already discussed the growing importance of this statement in a number of contexts including accounting for revaluations of tangible fixed assets in Chapter 5 and accounting for retirement benefits in Chapter 10.

One of the confusing aspects, especially so for the layperson, of pre-FRS 3 traditional accounting was the ambiguity surrounding the treatment of gains and losses which were thought sufficiently significant to be allowed to have an impact on the balance sheet but yet were not reflected in the profit and loss account, and were instead dealt with by direct transfer to and from reserves. A good example of this type of transaction was the unrealised surplus on the revaluation of assets.

The traditional profit and loss account was based on a 'narrow concept' of realisation that treats as profits only those gains that have resulted in the receipt of cash or the acquisition of assets that are reasonably certain to be turned into cash. Unrealised gains were shunted into reserves (because of the prudence convention, anticipated losses were generally taken to the profit and loss account) and were reported as part of the movement of reserves, a statement the significance of which was not readily appreciated by many users of financial statements.

FRS 3 did not fundamentally challenge the narrow concept of realisation but, in drafting the standard, the ASB emphasises that gains and losses may be excluded from the profit and loss account only if they are specifically permitted or required to be taken to reserves by an accounting standard or, in the absence of a relevant accounting standard, by law (Para. 37). However, even with this stipulation the ASB believes that an incomplete impression of the company's financial performance would be obtained if attention were directed exclusively to the profit and loss account.

Accordingly, FRS 3 requires that companies publish an additional primary statement, which should be presented with the same prominence as the other primary statements, the 'Statement of Total Recognised Gains and Losses', which shows the total of recognised gains and losses in so far as they are attributable to shareholders.

As we pointed out in Chapter 4, the ASB now takes a more relaxed attitude to realisation and in particular the extent to which unrealised gains and losses should be kept out of the profit and loss account. The important distinction, argues the ASB, is not between realised and unrealised gains and losses but between those which derive from operating activities and those which derive from changes in the value of those assets and liabilities that are held on a continuing basis for use in the entity's business and which provide its infrastructure. It is suggested that changes in value that do not directly affect current trading (including those resulting from the disposal of infrastructure assets) should be reported separately from the result of operating and financing.

Hence the ASB requires that 'gains and losses on those assets and liabilities that are held on a continuing basis primarily in order to enable the entity's operations to be carried out are reported in the statement of total recognised gains and losses, and not in the profit and loss account' while 'all other gains and losses are reported in the profit and loss account' (Paras 6.27 and 6.28).

The *Statement of Principles* goes further in this direction by not referring to realisation at all. In the context of the entity's operating cycle gains should be recognised at the incidence of the *critical event*³ that normally occurs when the reporting entity has completed all its obligations while, in the case of revaluation, the critical consideration is reliability of measurement.⁴

³ *Statement of Principles*, Para. 5.33.

⁴ *Statement of Principles*, Para. 6.19.

The illustration in FRS 3 of the statement of total recognised gains is reproduced below.

Statement of total recognised gains and losses	1993	1992
		<i>as restated</i>
	£ million	£ million
Profit for the financial year	29	7
Unrealised surplus on revaluation of properties	4	6
Unrealised (loss)/gain on trade investment	<u>(3)</u>	<u>7</u>
	30	20
Currency translation differences on foreign currency net investments	<u>(2)</u>	<u>5</u>
Total recognised gains and losses relating to the year	28	<u>25</u>
Prior year adjustment	<u>(10)</u>	
Total gains and losses recognised since last annual report	<u>18</u>	

It is, perhaps, worth making the obvious point that gains and losses should not be double counted.⁵ Hence, a gain that was previously recorded as unrealised should not be recognised again in the period in which it is realised. For example, the realisation of a profit previously recognised when a fixed asset was revalued would be reflected in the statement of the movement of reserves, where it would appear as a transfer from the revaluation reserve to the profit and loss account reserve.

The prominence given to the statement of total recognised gains and losses is an example of the 'information set' approach which the ASB hopes will divert the focus of attention from the single 'bottom line' figure of profit for the period.

Two additional notes

Reconciliation of movements in shareholders' funds

The profit or loss for the period together with any recognised gains or losses not reflected in the profit and loss account measures the performance of the company during the period, but there are other changes in shareholders' funds that affect the company's financial position, notably the declaration of dividends and the injection and withdrawal of capital. FRS 3 hence requires the publication of an additional note reconciling the opening and closing balance of shareholders' funds.

Reconciliation of movements in shareholders' funds	1993	1992
		<i>as restated</i>
	£ million	£ million
Profit for the financial year	29	7
Dividends	<u>(8)</u>	<u>(1)</u>
	21	6
Other recognised gains and losses relating to the year (net)	(1)	18
New share capital subscribed	<u>20</u>	<u>1</u>
Net addition to shareholders' funds	40	25
Opening shareholders' funds (originally £375 million before deducting prior-year adjustment of £10 million)	<u>365</u>	<u>340</u>
Closing shareholders' funds	<u>405</u>	<u>365</u>

⁵ We shall return to the subject of recycling later in this chapter.

The note may be included as a primary statement but, if it is, it should be shown separately from the statement of total recognised gains and losses (Para. 59).

It is important to see how the profit and loss account, statement of total recognised gains and losses and the reconciliation of movements in shareholders' funds fit together. This can best be seen by studying the comprehensive note showing the movement of reserves required by company legislation. The example shown below is consistent with the previous illustrations.

Reserves	<i>Share premium account</i> £ million	<i>Revaluation reserve</i> £ million	<i>Profit and loss account</i> £ million	<i>Total</i> £ million
At beginning of year as previously stated	44	200	120	364
Prior-year adjustment			(10)	(10)
At beginning of year as restated	44	200	110	354
Premium on issue of shares (nominal value £7 million)	13			13
Transfer from profit and loss account of the year			21	21
Transfer of realised profits		(14)	14	0
Decrease in value of trade investment		(3)		(3)
Currency translation differences on foreign currency net investments			(2)	(2)
Surplus on property revaluation		4	4	
At end of year	<u>57</u>	<u>187</u>	<u>143</u>	<u>387</u>

Note: Nominal share capital at end of year £18 million (1992 £11 million).

Note of historical cost profits and losses

If there is a material difference between the results disclosed in the profit and loss account and that which would have been produced by an 'unmodified' (i.e. no asset revaluations) financial statement, a note of the historical cost profit or loss for the period should be presented. The note should include a reconciliation of the reported profit on ordinary activities before taxation to the equivalent historical cost figure and show the retained profit from the financial year as would have been reported on the historical cost basis.

The more common types of adjustments that will be found include:

- (a) Gains recognised in prior periods in the statement of total recognised gains and losses but realised in the current period, as under the strict historical cost convention the whole of the gain would be reported in the current period.
- (b) The difference between the depreciation charges based on historical cost and such charges based on the revalued amounts.

The standard, at Para. 55, allows two exceptions:

- (a) adjustments made to cope with hyperinflation in foreign operations; and
- (b) the practice of market makers and other dealers in investments of marking-to-market value where this is an established industry practice.

Where full historical cost information is unavailable or cannot be obtained without unreasonable expense or delay, the earliest available values should be used.

The note should be presented immediately following the profit and loss account or the statement of total recognised gains and losses. The FRS 3 example of the note is presented below:

Note of historical cost profits and losses	<i>1993</i>	<i>1992</i> <i>as restated</i>
	£ million	£ million
Reported profit on ordinary activities before taxation	45	13
Realisation of property revaluation gains of previous years	9	10
Difference between a historical cost depreciation charge and the actual depreciation charge of the year calculated on the revalued amount	<u>5</u>	<u>4</u>
Historical cost profit on ordinary activities before taxation	<u>59</u>	<u>27</u>
Historical cost profit for the year retained after taxation, minority interests, extraordinary items and dividends	<u>35</u>	<u>20</u>

Two reasons are cited by the ASB to support the publication of this additional note:

- Undertakings are allowed to decide whether to revalue assets and, if so, when. The results of undertakings that have revalued assets at different times are thus not comparable but the strict historical cost profit figures can be compared.
- Some users of financial statements wish to assess the profit or loss on the sale of assets on the basis of their historical cost rather than, as required by the standard, on their revalued carrying amount.

Review of FRS 3

Accountants have struggled for a long time to find a way of separating out unusual items in order to help users make an informed judgement of the progress of the company and estimate its potential for the future. FRS 3 was an important milestone in that development.

Its provisions have resulted in the production of far more complex profit and loss accounts than had traditionally been produced, a development in tune with the view of the ASB that the desire for understandability should not mean that complex items should be excluded from financial statements if the information is relevant to decision making.⁶

A number of factors have led to the recognition that a review of the standard was appropriate, particularly the view that, although the ASB had made great strides with FRS, 3 there remained a number of areas, such as the treatment of gains and losses on assets, that would benefit from further work.

As part of the move towards international harmonisation of accounting standards the first stage of the review was carried out at an international level and this has resulted in a publication that comes in two parts. The first part is the discussion paper itself, issued by the ASB, while the second part consists of a 'position paper' produced by the 'G4+1' of standard setters.

⁶ *Statement of Principles*, Para. 3.37.

Reporting financial performance: proposals for change

In the first part of the paper, the ASB sets out its thinking and poses questions that it would like answered in the consultative period; the detailed discussion is found in the second, international, part of the paper.

In its introduction, the ASB reiterates its view that the performance of a complex enterprise cannot be summarised by a single number and reaffirms its belief in the ‘information set’ approach, as introduced in FRS 3, which attempts to highlight a number of components of performance. However, this is not yet a view widely held by users, many of whom still give undue prominence to the profit and loss account at the expense of the STRGL.

The main points made in the paper which, as we will see, have been incorporated in FRED 22 *Revision of FRS 3 ‘Reporting financial performance’* (December 2000), are:

- the introduction of a single performance statement combining the profit and loss account and the STRGL;
- the final elimination of extraordinary items;
- that, in general, errors should be recognised in the year of discovery without separate identification;
- dividends should no longer be included in the statement of financial performance but instead be shown as part of changes in equity.

FRED 22 Revision of FRS 3

The exposure draft builds on the discussion paper and in particular proposes the use of a single performance statement. Some commentators have seen this as the elimination of the STRGL but this is a mistaken view for the main thrust of the proposal is an endeavour to ensure that users of the financial statements give the same consideration to the items that presently appear in the STRGL as they give to the profit and loss items.

Proposed performance statement

The proposed performance statement would include all gains and losses recognised during the period and be divided into three sections:

- operating section;
- financing and treasury section;
- other gains and losses.

The Board believes that use of a consistent approach to the ordering of items in the statement would be of value to users and that, as a practical matter, it would be generally possible to distinguish between those items that relate to an entity’s operations and those which relate to its financing and treasury activities. The ‘other gains and losses’ section would include holding gains and losses and arise from long-term items held for operating or financing purposes.

Recycling

The exposure draft proposes the elimination of recycling, whereby gains and losses are reported twice in the performance statements, when first recognised and subsequently when realised. Such an approach, which the Board has been championing vigorously for some

time, adds to the greater clarity of financial statements and indicates the fact that far less emphasis is now being given to realisation in financial reporting.⁷

Discontinued operations

We introduced, on p. 283, the four conditions set out in FRS 3 that have to be satisfied if an operation is to be treated as being discontinued. These included the provisions that the discontinuation must be completed either in the period or close to the period end, that any sale must be irrevocable and every termination permanent. In contrast, the corresponding international standard, IAS 35, *Discontinuing Operations* (1998), requires that operations should be shown as discontinuing from the time a binding sales agreement has been signed or a decision to sell/terminate has been made and announced, but it allows for the possibility that the decision might be reversed.

Respondents to the discussion paper generally agreed with the proposition that a decision to sell or terminate should be irrevocable; however, some support was expressed for relaxing the requirement that the operations must be sold or termination completed in the reporting period or very shortly after the period end. The view was expressed that discontinuations representing a material reduction in operating facilities could take place over quite a long time and that a move towards the international approach would be appropriate.

In drafting FRED 22 the Board adopted most of the proposals of IAS 35 in the spirit of international co-operation, although with some reluctance, and proposed the removal of the requirement that the decision should be irreversible. However, the exposure draft still contains a far more rigorous test for the recognition of a discontinuity than IAS 35 and the ASB believes that, due to the existence of the test, the removal of the irreversibility condition would only very rarely have any practical effect. The test is found in the definition of an *initial disclosure event* that in respect to a discontinuing operation requires the occurrence of one of the following events:

That the entity has entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation; or the entity's board of directors or similar governing body has both:

- i. approved a detailed, formal plan for the discontinuance: and
- ii. made an announcement of the plan, and the actions of the entity are such that they have raised a valid expectation in those affected that it will carry out the planned termination. (Para. 2)

Extraordinary items

Extraordinary items, already rare, may now finally disappear for, while FRED 22 still provides for their continued existence by including a definition of the term that is, other than for minor drafting changes, identical to that included in FRS 3, the Board now cannot envisage any circumstance in which extraordinary items might be reported under the definitions in the proposed standard (Para. 68).

Dividends

In the UK and the Republic of Ireland, company law requires that dividends be shown on the face of the profit and loss account, a treatment that might suggest that dividends are

⁷ See Chapter 4.

expenses rather than appropriations of profit. The ASB believes that it would be better, even given that changes in legislation would be required, to remove this confusion and show dividends as changes in equity. However, in order not to put too much distance between the operating results and the reporting of dividends, the draft proposes that dividends for the period should be shown as memorandum items at the foot of the performance statement, both in total and per share (Para. 96).

Notes to the financial statements

It is proposed that the note of historical cost profits and losses that is mandatory under the terms of FRS 3 (see p. 290) should now be optional (Para. 104). It is also proposed that, when exceptional items are reported in either the current year figures or those of a comparative period, a history of exceptional items reported should be shown in the notes to the statement. The note should show, for each of the last five years, a breakdown of the exceptional items reported with a description of each (Para. 63).

Compliance with international standards

The main differences between UK and international standards that would remain if the proposals of FRED 22 were implemented relate to the flexibility allowed in the presentation of the operating statements, the definition of discontinuity of operations and the treatment of losses and gains on the disposal of assets.

IAS 1 (revised 1997) *Preparation of Financial Statements*, requires the presentation of an income statement and a separate statement of changes in equity; the latter includes the net profit or loss for the period as reported in the income statement, but it is not described as a performance statement. In contrast, FRED 22 would require all gains and losses to be reported in a single primary performance statement. The exposure draft also divides the statement into sections and sets out requirements for the allocation of gains and losses to those sections. IAS 1 offers no particular order or groupings for gains and losses and no explanation as to why some gains and losses are reported in the income statement while some are reported in equity.

We have already pointed out (p. 293) that the FRED 22 test to decide whether a change in operational policy constitutes a discontinuity is more rigorous than the equivalent stipulation in IAS 35 *Discontinuing Operations*.

FRED 22 proposes that gains and losses on the disposal of fixed assets should be reported in the same way as revaluation gains and losses and impairment losses. The result is that gains on disposal (that are not reversals of previous impairments) and losses on disposal (that are not impairments), will be reported in other gains and losses (while impairments and their reversal will be reported in the operating section). This proposal would require a change to FRS 15. In contrast IAS 16 (revised 1998) *Property, Plant and Equipment*, requires gains or losses on disposal to be reported as income or expenses in the income statement for the period, while revaluation gains (that are not reversals of previous impairments) and revaluation losses (that are not impairments) are reported directly in changes in equity.

Post-FRED 22 developments

As at January 2003, the ASB was still engaged on a joint project with IASB in the area of reporting financial performance. The most recent publication providing details of the progress of the project is a Technical Note to be found on the ASB website.⁸ The proposals and intentions set out in the note build upon those contained in FRED 22 and have the following overriding objective

The objective of the format of the statement of comprehensive income is to categorise, order and display information so as to maximise predictive value with respect to forecasts of comprehensive income and its components.

In order to help achieve this objective the following principles were developed:

Principle 1: A statement of comprehensive income should be able to distinguish the return on total capital employed from the return on equity.

Principle 2: Components of gains and losses should be reported gross (that is they should not be set off) unless they give little information with respect to future income.

Principle 3: Income and expenses resulting from the re-measurement of an asset or liability should be reported separately.

Principle 4: A statement of comprehensive income should identify income and expenses where the change in economic value does not arise in the period in which it is reported.

Principle 5: Within the prescribed format and without the use of proscribed subtotals, the statement of comprehensive income should allow reporting in the form of:

- information on the entity as a whole, analysed by nature or function;
- the activities disaggregated by business segments (geographic or product-based);
- additional distinctions according to managerial discretion.⁹

The ASB and IASB have tentatively agreed to develop a statement format that makes two main distinctions based on principles 1 and 3 above. The proposed format would allocate items into one of four categories in a 2×2 matrix format.

The two rows in this matrix would be based on a 'business/financing' distinction defined by principle 1 above. The financing section would report the return to providers of finance (i.e. interest and the unwinding of discounts on liabilities); hence, the business section would provide a measure of financial performance that is independent of the capital structure of the entity.

The proposed columnar distinction is driven by principle 3. Income and expenses that result from the re-measurement of assets and liabilities would be reported separately in the second column. This column would therefore include items such as fixed asset revaluations and actuarial gains and losses on defined benefit pension schemes.

The shape of the resulting performance statement is shown in Figure 11.1. This format will probably be adapted for specialised industries such as banking and insurance.

The exposure draft based on the above proposals is scheduled for publication in the first half of 2003.

⁸ www.asb.org.uk.

⁹ ABS, Reporting Financial Performance, Technical Activities, ASB website: [www.asb.org.uk/publications/publication project.cfm?upid=66](http://www.asb.org.uk/publications/publication%20project.cfm?upid=66).

	Income and expenditure arising from activities carried out in the current period	Income and expenditure resulting from the re-measurement of assets and liabilities
Operating items		
Finance items		

Figure 11.1 Proposed structure for the performance standard

Segmental reporting

The financial statements of a company and the consolidated financial statements of a group summarise the results and financial position for the reporting entity as a whole. Thus, subject to the possible exclusion of one or more subsidiaries from consolidation in accordance with the provisions of FRS 2, the financial statements summarise all of the activities of the reporting entity, no matter how diverse these activities may be. Many companies and groups of companies operate in a number of different industries and in a number of different geographical areas, perhaps manufacturing in certain countries and supplying customers in other countries. The industrial and geographical segments of the entity are very likely to enjoy different levels of profitability, may be subject to very different risks and may have very different growth potentials. If users are to be able to assess past performance and to predict likely future performance of the entity as a whole, it is argued that it is necessary for them to be provided with a detailed analysis in respect of the individual segments. The provision of such an analysis is known as segmental, analysed or disaggregated reporting.

Company law and the Stock Exchange have accepted the need for such segmental reporting for many years although, as we shall see, their requirements are limited. An international accounting standard was first issued on this subject in 1981 and subsequently reformatted in 1994. A revised version of IAS 14 *Segment Reporting*, was issued in 1997 and this draws heavily on the US standard.¹⁰ In particular, the revised IAS 14 provides more guidance on the identification of segments and increases the disclosure requirements. As a consequence, SSAP 25 *Segmental Reporting*, which was issued in 1990, is now somewhat out of line with the revised IAS 14. Although the ASB considered possible changes to the standard in a Discussion Paper *Segmental reporting*, in 1996, it has concluded that, as there is general satisfaction with the present segmental reporting requirements, no further action will be taken at this time.¹¹

The requirements of the Stock Exchange and company law

We shall look first at the requirements of company law and the Stock Exchange before turning to the provisions of SSAP 25.

¹⁰ SFAS 131 *Disclosures about Segments of an Enterprise and Related Information*, June 1997.

¹¹ See 98 Financial Reporting Council, Annual Review, 1998, p. 47. Available on the FRC website, www.frc.org.uk.

So long as the disclosure of the information is not seriously prejudicial to the interests of the company, the Companies Act 1985 requires two analyses, the first where a company or group has carried on business of two or more classes that (in the opinion of the directors) differ substantially from one another, and the second where a company or group has supplied geographical markets that (in the opinion of the directors) differ substantially from each other.¹²

In the former case, the law requires a description of each class of business together with the turnover and the profit or loss before taxation attributable to each class whereas, for the geographical segments, the law requires only an analysis of turnover. For listed companies, the Stock Exchange increased the amount of disclosure by requiring 'a geographical analysis of both net turnover and contribution to trading results of those trading operations carried on . . . outside the United Kingdom and the Republic of Ireland', although the analysis of contribution is only required if the profit or loss from a specific area is out of line with the normal profit margin.¹³

The above requirements ensure the provision of a minimum amount of segmental information but leave a great many questions unanswered.

Although some would question the wisdom of leaving the selection of reportable segments to directors, this would seem to be inevitable given the variety and complexity of modern businesses.¹⁴ Perhaps a more serious problem is that any segmental analysis provided may be highly misleading if there is substantial trading between segments, especially if this trading occurs at artificially determined prices, and yet the law and the Stock Exchange do not require the disclosure of any inter-segment turnover or the basis of inter-segment pricing. Where an analysis of profit or contribution is required, there is the problem of how to deal with common or joint costs that are not directly attributable to any one segment; examples would be interest cost and the cost of a head office. In addition, the segmental information would appear to be of limited use without some indication of the net assets employed in each segment but, immediately an attempt is made to provide such an indication of net assets, the accountant confronts the problem of how to deal with common or joint assets, that is assets used by more than one segment. We would expect to turn to the accounting standard for guidance on the above matters.

SSAP 25 Segmental Reporting

While the standard contains some provisions relating to the statutory segmental disclosure, which therefore apply to all companies, it also extends these requirements to any entity that:¹⁵

- (a) is a public limited company or that has a public limited company as a subsidiary; or
- (b) is a banking or insurance company or group . . . ; or
- (c) exceeds the criteria, multiplied in each case by 10, for defining a medium-sized company under section 247 of the Companies Act 1985, as amended from time to time by statutory instrument.

¹² Companies Act 1985, Schedule 4, Para. 55(1) to 55(5).

¹³ See Stock Exchange, *Listing Rules*.

¹⁴ SSAP 25, Para. 9 defines a reportable segment by reference to the relative size of the segment, namely 10 per cent or more of external turnover, results or net assets.

¹⁵ SSAP 25, Para. 41.

Thus, segmental disclosure required by statute is increased for public companies and certain specialised companies as well as for large private companies, although such a large private company does not have to provide the additional information if its parent provides the required information.

The extent of the increase in disclosure may be seen in Para. 34 of the standard:

If an entity has two or more classes of business, or operates in two or more geographical segments which differ substantially from each other, it should define its classes of business and geographical segments in its financial statements, and it should report with respect to each class of business and geographical segment the following financial information:

- (a) turnover, distinguishing between (i) turnover derived from external customers and (ii) turnover derived from other segments;
- (b) result, before accounting for taxation, minority interests and extraordinary items; and
- (c) net assets.

The geographical segmentation should be given by *turnover of origin*, that is the area from which products or services are supplied and for which results and net assets will be determined. However, it should also be given by *turnover of destination* where it is materially different.¹⁶

The division of turnover between external sales and inter-segment sales undoubtedly helps users to appreciate the interdependence of segments, although the effect of such interdependence on results will be impossible to ascertain without some knowledge of the way in which inter-segment prices are determined. While IAS 14 requires disclosure of the basis of inter-segment pricing, SSAP 25 does not require this.

The standard provides guidance on determining segmental results and increases the legal provisions by requiring the disclosure of net assets for each segment. As a consequence it should be possible to compute returns on capital employed for the different activities of the business.

Results are to be taken before taxation, minority interests and extraordinary items and normally before taking account of any interest receivable or payable. Net assets will normally be the non-interest-earning operating assets less the non-interest-bearing operating liabilities. Only if the interest income or expense is central to the business of the segment should it be included in arriving at the segmental result when, for consistency, the assets or liabilities to which it relates should be included in the segmental net assets. Interest not so apportioned and other common revenues and costs should be excluded from the segmental analysis but included in the total results. Similarly, common assets and liabilities should be excluded from the segmental net assets but included separately as part of the total net assets. This is essential if the segmental analysis is to agree with the related totals in the financial statements of the company or group and, where such agreement is not apparent, a reconciliation must be provided.¹⁷

The Appendix to SSAP 25 contains an illustrative segmental report covering both classes of business and geographical segment. Table 11.2 illustrates the sort of segmental report envisaged for classes of business only, although, for simplicity, we have excluded comparative figures.¹⁸

¹⁶ SSAP 25, Para. 34.

¹⁷ SSAP 25, Para. 37.

¹⁸ Note that the table includes the aggregate share of the results and net assets of associated undertakings. This is required if such associated undertakings account for at least 20 per cent of its total results or 20 per cent of its total net assets (SSAP 25, Para. 36).

Table 11.2 Illustrative segmental report (excluding comparative figures)

<i>Classes of business</i>	<i>Industry</i>	<i>Industry</i>	<i>Group</i>
	<i>A</i>	<i>B</i>	
	£000	£000	£000
<i>Turnover</i>			
External sales	700	250	950
Inter-segment sales	50	–	50
Total sales	<u>750</u>	<u>250</u>	<u>1000</u>
<i>Profit before taxation</i>			
Segment profit	<u>150</u>	<u>100</u>	250
less Common costs			<u>60</u>
			190
Share of profit before taxation of associated undertakings	<u>40</u>	<u>–</u>	<u>40</u>
<i>Net assets</i>			
Segment net assets	<u>1 500</u>	400	1900
Unallocated assets			<u>100</u>
			2000
Share of net assets of associated undertaking	<u>300</u>	<u>–</u>	<u>300</u>
			<u>2300</u>

From Table 11.2 it is possible to compare the profit margin on sales and the return on net assets for each segment. Thus, it can be seen that the smaller segment, that is industry B, has the higher profit margin and the higher return on capital employed:

*Profit margin*Segment A $150 \div 750 = 20\%$ Segment B $100 \div 250 = 40\%$ *Return on net assets*Segment A $150 \div 1500 = 10\%$ Segment B $100 \div 400 = 25\%$

In practice such results could be compared with those for previous years to build up a picture of past trends and hence likely future progress. For example, given the results disclosed, an investor would be much happier if the involvement of the company or group in industry B were growing as a proportion of its total activity than if the involvement in industry A were growing.

By requiring the disclosure of inter-segment sales and of segmental net assets, the standard has certainly improved the usefulness of the legally required segmental disclosure. However, it will be more difficult to draw conclusions from a segmental report the higher

the level of inter-segment sales and the greater the proportion of common costs/revenues and common net assets.

Although, potentially, the segmental information should be of considerable benefit to users, the inevitable discretion permitted to directors may reduce that benefit substantially in practice.

Compliance with the international standard

There are a number of differences between SSAP 25 and IAS 14 *Segment Reporting* (revised 1997), in addition to the one relating to the disclosure of inter-segment pricing to which we have already referred. In general IAS 14 provides rather more guidance than SSAP 25 in such matters as definition of segments and of the elements to be disclosed.

IAS 14 adopts what has been termed a ‘management approach’ in that it places more stress on the organisational structure of the reporting entity in defining segments than does SSAP 25. It also adopts a primary and secondary reporting format whereby a decision is made as to whether the dominant source for different returns and risks is the different products of the entity or the different markets in which it operates. The dominant source provides the basis of the primary reporting segment, with the other being the basis for the secondary format. IAS 14 requires more information to be provided in respect of the primary source while SSAP 25 makes no such distinction. While these differences are on the surface quite significant, the flexibility allowed by SSAP 25 makes it possible to produce a statement that complies with both standards.¹⁹

Part B Extending the financial reporting envelope

Accounting for post balance sheet events

One of the desirable characteristics of accounting reports discussed in Chapter 1 was ‘timeliness’, i.e. the need to publish financial statements as quickly as possible. However, there will inevitably be some delay between the end of the accounting period and the date of publication (which is not to say that the duration of the delay could not often be reduced), and this leads one to the question of how the accountant should treat significant events which occur during this period.

SSAP 17 Accounting for Post Balance Sheet Events

The main principle underlying SSAP 17 *Accounting for Post Balance Sheet Events*, issued in 1980, is that users should be presented with information that is as up to date as possible and be informed of any significant events that have occurred since the end of the accounting period. The provisions are uncontroversial and straightforward and may therefore be briefly summarised.

A distinction is drawn between events that occur before and after the date on which the directors approve the financial statements, and the standard covers only those events that

¹⁹ *International Accounting Standards: A Guide to Preparing Accounts* (2nd edn), ABG, London, 2000, Para. 16.13.

occurred prior to the date of approval. The point is made, however, that directors have a duty to ensure the publication of details of any events that occur after the date of approval if they have a material effect on the financial statements.

The date of approval is normally the date of the board meeting at which the financial statements are formally approved. In the case of consolidated financial statements, the date is that on which those statements are approved by the directors of the holding company.

Post balance sheet events are classified as either *adjusting* or *non-adjusting* events.

Adjusting events are those that provide additional evidence in respect of conditions existing at the balance sheet date and will therefore call for the revision of the amounts at which items are stated in the financial statements. A very obvious example of an adjusting event would be the receipt of cash from a debtor that could affect the provision against doubtful debts. Events such as the proposal of a dividend, a transfer to reserves and a change in the tax rate are also regarded as being adjusting events but the treatment of dividends would change if the provisions of FRED 27 *Events after the Balance Sheet Date* (May 2002), were implemented.

Non-adjusting events are those that do not relate to conditions existing at the balance sheet date and will not affect the figures included in the financial statements. Examples of non-adjusting events are the issue of shares, major changes in the composition of the company and the financial effect of the losses of fixed assets or stocks as a result of a disaster such as fire or flood. The last-mentioned instance is an example of a non-adjusting event because the fire or flood would not affect the condition of the asset concerned at the balance sheet date.

The standard also requires the disclosure, as a non-adjusting event, of the reversal after the balance sheet date of transactions undertaken before the year end with the prime intention of altering the appearance of the company's balance sheet. These alterations comprise those commonly referred to as 'window dressing'; for example, the borrowing of cash from an associated company to disguise an acute short-term liquidity problem.

It may be that some event occurs after the balance sheet date which, because of its effect on the company's operating results or financial position, puts into question the application of the going concern convention to the whole (or to a significant part) of the company's financial statements. The standard (Para. 22) requires that the financial statements should be amended as a consequence of any material post balance sheet event which casts doubt on the application of the going concern convention, even though Para. 21 specifies that the financial statements should be prepared on the basis of conditions existing at the balance sheet date. FRED 27 is more logical and does not include an equivalent provision to that set out in Para. 22.

The actual standard may be summarised as follows:

- 1 Financial statements should be prepared on the basis of conditions existing at the balance sheet date.
- 2 A material post balance sheet event requires changes in the amounts to be included in financial statements where:
 - (a) it is an adjusting event; or
 - (b) it indicates that the application of the going concern concept to the whole or a material part of the company is not appropriate. (Note that this seems to conflict with requirement 1.)
- 3 A material post balance sheet event should be disclosed where:
 - (a) its non-disclosure would hinder the users' ability to obtain a proper understanding of the financial position; or
 - (b) it is the reversal or maturity after the year end of a transaction, the substance of which was primarily to alter the appearance of the company's balance sheet (window dressing).

- 4 In respect of any material post balance sheet event which has to be disclosed under the provisions of (3) above, the following should be stated in the notes to the accounts:
- (a) the nature of the event; and
 - (b) an estimate of its financial effect or a statement that it is not practicable to make such an estimate. The financial effect should be shown without any adjustment for taxation but the taxation implications should be explained if such is necessary to enable a proper understanding of the financial position to be obtained.
- 5 The date on which the financial statements were approved by the Board of Directors should be disclosed.

It should be noted that the Companies Act 1985 requires that all liabilities and losses in respect of the financial year (or earlier years) shall be taken into account, including those which only became apparent between the balance sheet date and the date of the approval of the financial statements.

FRED 27 Events after the Balance Sheet Date

This exposure draft was issued on May 2002 as part of the international harmonisation programme and differs from SSAP 17 in a number of ways.

Dividends no longer adjusting events

The SSAP 17 definition of an adjusting event includes the phrase ‘events which because of statutory or conventional requirements are reflected in financial statements’.²⁰ The effect of this is that financial statements include dividends that are declared after the year end even though the subsequent declaration of a dividend does not affect the condition of the entity at the balance sheet date. The exposure draft proposes that this inconsistency, resulting from a reluctance to challenge existing legal practice that is inherent in SSAP 17, should not be carried forward to a new standard. The same change is being proposed in the corresponding international standard IAS 10 *Events after the Balance Sheet Date*. The convergence that would be achieved if the proposed changes to the UK and international standards were implemented would be accompanied by a divergence between UK company law and UK accounting standards in that Para. 3(7) of the Fourth Schedule to the Companies Act 1985 requires that paid and proposed dividends should be shown in the profit and loss account.²¹ The necessary changes are being considered as part of the general review of company law.

Dividends from subsidiaries and associates declared after the balance sheet date

A change equivalent to the above is being proposed in respect of dividends from subsidiary and associate companies declared after the investing company’s balance sheet date. SSAP 17 regards these as adjusting events, FRED 27 does not.

²⁰ SSAP 17, Para. 19.

²¹ The equivalent provision in the Republic of Ireland is s. 4(15)(a) of the Companies Amendment Act 1986.

Adverse events and prudence

We pointed out earlier (p. 301) the inherent inconsistency contained in SSAP 17 in that, for reasons of prudence, Para. 22 of SSAP 17 requires that events that took place after the balance sheet date that cast doubt on the continuing application of the going concern concept, but did not affect the condition of the entity at the balance sheet date, might be regarded as an adjusting event. The prudence point is made in more general terms in the Appendix to the standard which states that, in exceptional circumstances, in order to accord with the prudence concept, an adverse event which would normally be classified as non-adjusting may need to be reclassified as adjusting. The more rigorous logical approach adopted by FRED 27 means that it does not contain similar provisions, although an event of the criticality that would put the future application of the going concern convention in doubt would need to be shown as a non-adjusting event with a note showing its likely financial effect.²²

Compliance with the international standard

There would be no material differences between the UK and international standard if the proposed changes are implemented.

Earnings per share

One of the most widely used measures in finance is a share's price/earnings (P/E) ratio, that is the share's market value divided by the related earnings per share. Suppose:

- The ordinary shares of Wayne plc had a market value of £12 at 31 December 20X1.
- The most recent financial statements available for the company show a profit of £32m for the year to 30 September 20X1.
- The company has in issue 40 million ordinary shares but no preference or other shares.

The earnings per share (EPS) for the year ended 30 September 20X1 = $\pounds(32/40) = \pounds0.8$ and the best estimate of the P/E ratio as at 31 December 20X1 = $12/0.8 = 15$. This is a best estimate because, like every price/earnings ratio, it relates the current market price with a historical figure for EPS.

The P/E ratio indicates the number of years it would take for investors to recoup their investment, in the above example 15 years. But things do indeed change and the current P/E ratio indicated the market expectation about how things will change; a high P/E ratio indicates that the market expects that the EPS will grow.

The market provides the price but the financial statements produce the EPS and so, given the wide use of the measure, it is not surprising to find that one of the first statements issued by the ASC covered this topic. The standard was SSAP 3, *Earnings per Share*, which was issued in 1972. While the calculation of earnings per share has had to change over the years, in particular because of changes in tax law and because of the gradual elimination of the special treatment of extraordinary items, the basic principles underlying SSAP 3 have

²² FRED 27, Para. 20. It is rather odd that in the relevant section of the preface to FRED 27, dealing with the proposed changes to existing standards, reference is made to the removal of the phrase in the Appendix but not to the removal of the provision contained in Para. 22.

survived remarkably well. In fact in the section dealing with the development of its successor, FRS 14, also called *Earnings per Share* (1998), the ASB accepted that SSAP 3 was operating reasonably effectively and that the only reason for revising it was international developments in the area.²³

FRS 14 *Earnings per Share*

Since the reason for the importance of reporting of EPS is its use in calculating a share's price earnings ratio, FRS 14 covers only those entities whose ordinary shares or potential ordinary shares are publicly traded and those entities that are in the process of issuing ordinary or potential ordinary shares in public security markets. Potential ordinary shares are financial instruments or rights that may entitle the owner to ordinary shares and these include convertible preference shares, options and rights granted under employee share plans.

The earnings to be used in the calculation are the net profit or loss for the period attributable to ordinary shareholders after deducting dividends and other appropriations in respect of non-equity shares. In the case of cumulative preference shares the amount to be deducted is the maximum dividend for the period irrespective of whether or not the full dividend was declared.

The definition of earnings is pretty straightforward, the complications arise with the denominator, the number of shares, and these relate to actual and possible changes in the capital structure that have changed, or may change, the number of equity shares in issue.

We will first discuss the treatment of actual changes in capital structure, which we shall do by considering a number of hypothetical examples.

Assume that MM plc's earnings attributable to equity shareholders for 20X5 is £2.0 million and that at 1 January, the start of its financial year, it had in issue 20 million ordinary shares of 25p each and that on 1 October it issued a further 4 million 25p ordinary shares. What is the EPS for 20X5? The answer depends on the nature of the issue, specifically whether it was a scrip (or bonus) issue or whether the issue was for cash (or other consideration) and, if for cash, etc., whether the issue was at, or below, the market price.

Scrip issue

A scrip issue does not raise extra cash and merely represents a rearrangement of the equity interest in a company in that a transfer is made from reserves to equity share capital. There are simply more shares in issue at the end of the year than there were at the beginning and, hence, to show the EPS appropriate to the new capital structure, all that is required is to apportion the earnings over the shares in issue at the year end, 24 million, and thus the EPS is $(£2\,000\,000 \div 24\,000\,000) \times 100 = 8.3\text{p}$.

To assist comparability, the EPS for the corresponding period should be adjusted accordingly. Similar considerations apply if shares are split into shares of a smaller nominal value.

Issue at full market price

Let us now assume that the issue of shares was made at the full market price, while recognising that in practice such an issue is nowadays a rare event, as most issues for cash take the form of rights issues to existing shareholders at a price below that which prevails on the

²³ FRS 14, p. 48.

market. To calculate the EPS where there has been an issue at the full market price all that is necessary is to calculate the weighted average number of shares in issue in the course of the year and divide the result into the total earnings of the year. The average is weighted to take account of the timing of the share issue.

In this case the company had 20 million shares in issue for 9 months and 24 million for 3 months. The appropriate weightings to be applied are hence $\frac{3}{4}$ and $\frac{1}{4}$ and the weighted average is $\frac{3}{4} \times 20\,000\,000 + \frac{1}{4} \times 24\,000\,000 = 21\,000\,000$, while the new EPS is $(£2\,000\,000/21\,000\,000) \times 100 = 9.5\text{p}$.

It will be noted that this figure exceeds the 8.3p per share in the scrip issue example and it will be instructive to consider why this is so. A company which makes a scrip issue raises no extra resources and hence, all other things being equal, will not increase its earnings. Thus, the only effect of the scrip issue is to divide the earnings over a greater number of shares. In contrast, if shares are issued for cash, extra resources are obtained which, it is hoped, will increase earnings in the future. If the new investment generates the same rate of return as the existing assets of the business, then, all other things being equal, the EPS after an issue at the full market price will be the same as that which prevailed before the issue. However, in practice it will take some time to deploy the additional resources and in the first instance the additional cash will earn a small or even a negative return, hence the issue of shares for cash will normally reduce the EPS (from that which applied before the issue) until the new investment comes on stream.

Rights issue

A rights issue lies somewhere between the two extremes of a scrip issue and an issue at the full market price in that it combines elements of both, since while additional cash is raised the original shares lose some of their value.

In order to distinguish between the two elements of a rights issue it is necessary to find what is called the *theoretical ex-rights price*. This is the price per share following the issue which would make the stock market value of the company immediately after the rights issue equal to the sum of the market value before the announcement of the issue and the proceeds of the rights issue.²⁴ Once the theoretical ex-rights price is determined, the EPS calculation can be made on the assumption that there were two transactions: a scrip issue followed by an issue at the new market price.²⁵

Let us assume that a company, RIG plc, has in issue 12 000 shares which had a market price of £2 and eight months after the start of the year RIG makes a rights issue of one for every three shares held (a 1 for 3 issue) at a discount of 25 per cent, i.e. 4000 shares were issued at a price of £1.50 each, so raising £6000. The theoretical ex-rights price, x , is given by:

$$\begin{aligned} 16\,000x &= 12\,000 \times £2 + 4000 \times £1.5 \\ 16\,000x &= £24\,000 + £6000 \\ x &= £1.875 \end{aligned}$$

We need to find the size of a hypothetical scrip issue which would, all other things being equal, have reduced the market price per share from £2 to £1.875.

²⁴ The actual price per share following the issue is not likely to be equal to the theoretical ex-rights price as the actual price is likely to be affected by the market's expectations of future results and dividend policy. It might, for example, be thought that the total dividend per share would at least be held constant following the issue.

²⁵ Or the other way round.

Let X be the number of shares in issue following the scrip issue:

$$\text{then } X \times \text{£}1.875 = 12\,000 \times \text{£}2$$

$$\text{or } X = 12\,000 \times \frac{\text{£}2}{\text{£}1.875} = 12\,800$$

Thus the scrip issue would be such as to increase the number of shares in issue from 12 000 to $(12\,000 \times 2/1.875)$. We should note that the factor $2/1.875$ is the:

$$\frac{\text{Actual market price (or fair value) before the issue}}{\text{Theoretical ex-rights price}}$$

We can now divide the rights issue into its two elements (a) the scrip issue and (b) the issue at the market price (or, in this case, at the theoretical ex-rights price).

Thus:

- (i) The company started with 12 000 shares.
- (ii) The hypothetical scrip issue increased the number of shares to $12\,000 \times 2/1.875$, i.e. an additional 800 shares.
- (iii) The hypothetical issue of 3200 shares at £1.875 raised £6000.

Thus the company finished with 16 000 shares.

To calculate the EPS, it is necessary to remember that, in the case of a scrip issue, the earnings were simply divided by the number of shares ranking for dividend at the end of the year (irrespective of the date of the scrip issue), whereas in the case of an issue at market price the average number of shares was used (weighted on the basis of the time of the issue). To combine these two methods we draw a line after the hypothetical scrip issue and say that at the end of eight months there were 12 800 ($12\,000 \times 2/1.875$) shares in issue but, as the increase was due to a scrip issue, we will calculate the EPS on the assumption that the company had 12 800 shares for the whole of the eight-month period. Thus, the weighted average number of shares will be calculated on the basis that the company had $12\,000 \times 2/1.875$ shares for eight months and 16 000 shares for four months. The weighted average number of shares is then:

$$12\,000 \times \frac{2}{1.875} \times \frac{2}{3} + 16\,000 \times \frac{1}{3} = 13\,867$$

and, if the earnings for the year were £1664, the EPS would be 12p.

The method described above is that set out in Para. 24 of FRS 14 which states that the factor that should be used to inflate the number of shares prior to the issue to adjust for the bonus element should be:

$$\frac{\text{Fair value per share immediately before the exercise of the rights}}{\text{Theoretical ex-rights value per share}}$$

In order to aid comparability, the EPS figure for the prior year needs to be adjusted to take account of the hypothetical scrip issue. If 12 000 shares were in issue for the whole of the preceding year then, for the purposes of restating the EPS, this figure needs to be increased

to 12 800, i.e. to $12\,000 \times (\text{fair value})/(\text{theoretical ex-rights price})$. Actually, a short-cut can be taken as the same result can be obtained by multiplying the original EPS by the reciprocal of the above ratio, i.e. by $(\text{theoretical ex-rights price})/(\text{fair value})$.²⁶

Dilution

If, at the balance sheet date, the company has contracted to issue shares at some time in the future, the effect may be to dilute (reduce) the EPS in future. The same might happen if at the balance sheet date the company has already issued shares which have not yet ranked for dividend (and hence which have been excluded from the EPS calculation) but which may do so in the future. In such cases FRS 14 requires that the fully diluted EPS be shown on the face of the profit and loss account together with the basic EPS. In addition:

- (a) equal prominence should be given to both the basic and the fully diluted EPS;
- (b) the basis of calculation of the basic and the diluted EPS figure should be disclosed.

Examples of financial instruments that might be converted to ordinary shares include options, warrants and convertible preference shares.

Note the use of the word *diluted*: if the potential change in the capital structure will lead to an increase in the EPS there is no need to calculate and display a different EPS figure. The test of whether a potential ordinary share is dilutive can be illustrated by reference to the conversion of preference shares.

There are two impacts on the EPS figure of such a change. The profit available to equity shareholders will increase because of the elimination of the preference dividend and this will increase the EPS but, as a result of the operation, there are more equity shares in issue and this will reduce the EPS. It will all depend on where the balance falls as to whether the convertible preference shares need to be treated as *dilutive potential ordinary shares*. Consider the following example.

Suppose that a company has a net profit available to ordinary (equity) shareholders of £2 million and has 5 million shares outstanding. The EPS is 40 pence.

Further suppose that the company has in issue £3 million convertible 15% preference shares that are convertible:

- Case 1, at one ordinary for one preference;
- Case 2, at one ordinary for three preference.

In either case the conversion would increase the net profit attributable to ordinary shareholders by £0.45 to £2.45 but in case 1 the number of ordinary shares would increase to 8 million and the EPS would become 31 pence, while in case 2 the number of ordinary shares would only increase to 6 million which would produce an EPS of 41 pence.

Hence, only in case 1 do we have dilutive potential ordinary shares and would be required to disclose a full diluted EPS alongside the basic EPS.

In determining whether potential ordinary shares are, or are not, dilutive the yardstick to be used is the profit or loss from continuing operations. Since by definition discontinued operations have ceased they are not relevant to the question of whether or not the issue of the shares will of itself reduce EPS.

²⁶ Let P be the original EPS, P' the restated EPS, E the earnings, S the original number of shares in issue and F the ratio of the cum rights to the theoretical ex-rights price. Then:

$$P = \frac{E}{S} \text{ and } P' = \frac{E}{SF} = P \times \frac{1}{F}$$

If a company has more than class of potential ordinary in existence the order in which the exercise is done may affect the outcome. Therefore, in order to maximise the dilution of basic EPS, each issue or series of potential ordinary shares is considered in sequence from the most dilutive to the least dilutive.²⁷

Contingently issuable shares

As the name suggests *contingently issuable shares* are those which will be issued depending on the outcome of a single event or a series of events. The standard makes it clear in a number of places that the EPS measure that emerges from the application of the rules of FRS 14 is a historical measure and not a prediction about the future. To give an example, suppose that a group of senior executives are offered shares if the average profit of a three-year period exceeds £40 million (assume for the sake of simplicity that a loss of any amount would be treated as zero for the purposes of the calculation) and that the profits for the first two years of the period amount to £115 million, that is £5 million short of the target. It does seem pretty certain that, short of an unexpected disaster, the goal will be achieved and the shares issued, but FRS 14 would not take these shares into account, as it treats the end of the reporting period as the end of the contingency period. The ASB accepts that there are arguments for adopting a different approach based on a projection of the future, but comes down against mainly, it seems, because it is not the method chosen by the IASB.

FRED 26 Earnings per Share

There are no differences in substance between FRS 14 and FRED 26; as we stated earlier the basic approach has stood the test of time. Perhaps the more significant changes relate to disclosure:

- FRED 26 proposes that basic and diluted EPS figures for both the net profit or loss for the period and also the profit and loss from continuing operations should be published on the face of the profit and loss account. FRS 14 does not require the publication of the figures for continuing operations.
- FRS 14 encouraged entities to provide additional EPS amounts which could be published in any part of the financial statements, the only stipulation being that they were not given greater prominence than the basic and diluted figures. Under the provisions of the FRED, all additional measures would need to appear in the notes, the only exception being EPS figures for discontinued operations.

Compliance with the international standard

The corresponding international standard is IAS 33 *Earnings per Share*, which is also under review. The text of FRED 26 is based closely on the text of the proposed revised IAS 33 and there are no material differences between the two sets of proposals.

²⁷ FRS 14, Para. 61.

Related party disclosures

Under traditional economic theory, a company is assumed to act in the interests of its owners, the equity shareholders, but, as we have seen in earlier chapters, many people have an interest in the affairs of a company and often the interests of different groups and individuals will conflict with one another. Companies must be managed and, in practice, directors and managers have to learn how to deal with these conflicting interests. Indeed, the directors and managers may well find themselves in a position where decisions which have to be taken on behalf of the company may be of considerable relevance, and possibly of benefit, to themselves in a private capacity. As has often been noted, it is a question of which hat is being worn, and the law and accounting standards try to ensure adequate disclosure of directors' interests and the benefits that they receive.

Another obvious example of a possible conflict of interest is where one company is controlled by an individual or another entity and enters into transactions with that 'related party' which are in the interest of the other party, rather than in the interest of the company itself.

The Department of Trade and Industry has investigated many cases involving related party transactions, including that of Pergamon Press Limited in 1969. The Chairman of Pergamon Press was Robert Maxwell and it is perhaps no coincidence that the impetus for related party disclosures stemmed from the scandal involving Robert Maxwell, Mirror Group Newspapers, Maxwell Communications Corporation and the Mirror Group Pension Funds that eventually surfaced in the early 1990s.

Various branches of the law, including company, trust and criminal elements, take more than a passing interest in the abuses which can flow from the existence of related party transactions, but our purpose here is confined to the disclosure issues involved.

There are two reasons why disclosure is required:

- 1 If transactions are not at arm's length, the users of financial statements may be misled; in particular, the financial statements may not provide a satisfactory basis for the prediction of future results. This would, of course, affect both parties to the transaction with the results of one party being overstated and those of the other party being understated. Disclosure might indicate the extent to which those with a legitimate interest in the company have gained or lost as a consequence.
- 2 Even in the absence of transactions, knowledge of the existence of a related party which controls the reporting entity will warn users that they may be subject to the effects of such transactions in future.

ED 46 *Disclosure of Related Party Transactions*, published by the ASC in 1989, proposed that companies should disclose abnormal transactions with related parties. By restricting the disclosure to abnormal transactions, it hoped to avoid lengthy disclosures. However, many commentators stressed the impossibility of distinguishing between normal and abnormal transactions and, when FRED 8 *Related Party Disclosures*, was issued in 1994, it followed international practice by requiring disclosure of all related party transactions. Both IAS 24 *Related Party Disclosures* (reformatted in July 1994), and FRS 8 *Related Party Disclosures* (November 1995), adopt this approach as has the exposure draft with the same name, FRED 25, issued in May 2002.

FRS 8 Related Party Disclosures

FRS 8 has as its objective:

. . . 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. (Para. 1)

Thus it is a standard concerned with disclosure rather than measurement, although the existence of the standard may, of course, affect the amounts shown in the financial statements where the need for disclosure causes changes in the behaviour of the related parties.

The required disclosure may be summarised under two headings:

- 1 *Disclosure of existence and name of controlling party.* Where the reporting entity is controlled by another party, it is required to disclose the relationship and the name of the controlling party and, if different, that of the ultimate controlling party. This information is required whether or not any transactions have taken place between the controlling parties and the reporting entity in a particular year. Even if no transactions have occurred, the existence of a relationship which may give rise to such transactions in future is important information for those using the financial statements (Para. 5).

For the purpose of FRS 8, control is defined as ‘the ability to direct the financial and operating policies of an entity with a view to gaining economic benefits from its activities’ (Para. 2.2).

- 2 *Disclosure of material transactions with related parties.* The reporting entity should disclose material transactions with a related party, irrespective of whether a price is charged, and this disclosure should include:
 - (a) the names of the transacting related parties;
 - (b) a description of the relationship between the parties;
 - (c) a description of the transactions;
 - (d) the amounts involved;
 - (e) any other elements of the transaction necessary for an understanding of the financial statements;
 - (f) the amounts due to or from related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date;
 - (g) amounts written off in the period in respect of debts due to or from related parties (Para. 6).

Related party transactions include purchases and sales of goods, purchases or sales of property, rendering or receiving of services, agency arrangements, licence agreements and management contracts. However, in order to avoid excessive detail, the standard normally permits transactions to be disclosed on an aggregated basis.

The definition of related parties

The purpose of the standard is clear; all that remains is to examine the definition of related parties. The key element in the definition is that the relationship between two or more parties is such that, through either influence or control, the interest of one of the parties may be subordinated to the interests of one of the other parties. In the words of FRS 8:

Two or more parties are related parties when at any time during the financial period:

- (i) one party has direct or indirect control of the other party; or
- (ii) the parties are subject to common control from the same source; or
- (iii) one party has influence over the financial and operating policies of the other party to an extent that that other party might be inhibited from pursuing at all times its own separate interests; or
- (iv) the parties, in entering a transaction, are subject to influence from the same source to such an extent that one of the parties to the transaction has subordinated its own separate interests. (Para. 2)

The standard provides two lists of related parties. One list consists of those which are automatically deemed to be related parties; the other of those who are presumed to be related parties unless there is evidence that neither party has influenced the financial and operating policies of the other in such a way as to inhibit the pursuit of its own separate interests. The first list therefore consists of those who are automatically guilty, whereas the second consists of those who are presumed guilty unless they can prove their innocence, a task which seems, philosophically, rather difficult. The lists are summarised in Table 11.3.

Table 11.3 Lists of related parties

<i>Automatically related parties</i>	<i>Presumed related parties unless there is evidence to the contrary</i>
Parent, subsidiaries and fellow subsidiaries	Key management of reporting entity or its parent
Associates and joint ventures	Person owning or able to control over 20 per cent of voting rights
Investors or venturers in respect of which the reporting entity is an associate or joint venture	Each person acting in concert in a way to exercise control or influence
Directors of the entity or its parent	An entity managing or managed by the reporting entity under a management contract
Pension fund for the benefit of employees in the reporting entity or a related party	
	<i>Other presumed related parties</i>
	Members of the close family of any individual deemed or presumed to be a related party. Partnerships, companies, trusts or other entities in which any individual or member of the close family deemed or presumed to be a related party has a controlling interest

Notes:

- (a) Where the parent is itself a subsidiary, the references to parent include the ultimate parent as well as any intermediate parent.
- (b) Close members of the family of an individual are those family members, or members of the same household, who may be expected to influence, or be influenced by, that person in their dealings with the reporting entity.

The lists are long but a number of exemptions are granted. So, for example, parties which can influence the behaviour of the reporting entity through their economic or commercial relationship with it are excluded. Thus, Para. 4 of the standard makes it clear that disclosure is not required of transactions with providers of finance, utility companies, government bodies, customers and suppliers, even where there is economic dependence. It recognises that such relationships may be extremely important but only requires disclosure if the entities mentioned fall within the definitions of related parties.

Fellow group members are obviously related parties but it would be extremely burdensome to report in detail on transactions between group members. Hence Para. 3 allows a number of exemptions which may be summarised as follows:

- (a) It is not necessary to disclose in consolidated financial statements any inter-group transactions which have been eliminated on consolidation although it is, of course, necessary to disclose transactions with other related parties.
- (b) It is not necessary to disclose related party transactions in a parent company's own financial statements where these are presented with consolidated financial statements.
- (c) Where a subsidiary undertaking has 90 per cent or more of its voting controlled within a group, it is not necessary to disclose transactions with group entities provided that consolidated financial statements including the subsidiary undertaking are publicly available.

It also includes two other more specific exemptions:

- (d) It is not necessary to disclose pension contributions paid to a pension fund.
- (e) It is not necessary to disclose emoluments in respect of services as an employee of the reporting entity.

There are no exemptions for small companies and it is perhaps not surprising that no such exemptions are envisaged.

Materiality

The definition of related parties is widely drawn and the potential disclosure under FRS 8 is enormous. Are there ways of reducing the volume? The early approach of only reporting abnormal items was rejected but there still remains our old friend materiality, which might be relied on to reduce some of the noise. FRS 8, Para. 20, specifically refers to materiality by stating that 'transactions are material when their disclosure might reasonably be expected to influence the decisions made by the users of general purpose financial statements'. This could be used to avoid reporting many transactions with related parties but there is a sting in the tail. Paragraph 20 goes on to state that materiality must be judged, not only in terms of the reporting entity, but also in relation to the other related party where that party is a director, a key manager or other person who can influence the entity, a member of their close family or an entity controlled by the individual or close family member. Thus an amount that is quite small from the point of view of the reporting entity might still have to be reported if it is judged to be large from the point of view of the other party!

FRED 25 Related Party Transactions

While the basic principles are maintained there are a number of differences between FRED 25 and FRS 8, the most significant one being that the exposure draft does not require the publication of the names of the transacting related parties.

In general, FRED 25 gives less guidance, or perhaps is less directive, than the FRS in a number of areas including the determination of the nature of influence that would trigger related party status. The exposure draft states that such a relationship exists where a party has an interest that gives it a significant influence over an entity, where significant influence is defined as the power to participate in the financial and operating policy decisions of an entity. FRS 8 goes further by describing the necessary level of influence as being such that the interest of one of the parties may be subordinated to the interests of one of the other parties.

The exposure draft does not refer to materiality in the context of disclosure and hence the more general policies relating to materiality will apply. This means that materiality will be judged only in the context of the reporting entity and not in relation to the circumstances of the related party.

Other changes include:

- only wholly owned subsidiaries would be exempt from the requirement to disclose transactions with group entities; the cut-off point under FRS 8 is 90 per cent;
- the exemption from the requirement to disclose pension contributions is not included in FRED 25.²⁸

Compliance with the international standard

FRED 25 is based on the text of the proposed revision of IAS 24, *Related Party Disclosures*; the only significant difference is that FRED 25, unlike the proposed amended IAS 24, includes a provision for the identification of the identity of the controlling party. IAS 24 only requires a statement that there is a controlling party. The ASB is of the view (which is not unreasonable) that the identity of the controlling party is relevant to the users. While the ASB has, with this exception, based FRED 25 on the IASB's proposals it continued to press its views that a number of the provisions of FRS 8 should be retained, including the clearer guidance on the degree of influence that constitutes control, the definition of materiality, the naming of the transacting related parties and the retention of the 90 per cent cut-off point for allowing exemptions for subsidiaries.²⁹

Part C Share-based payments

The practice of acquiring goods and services through the issue of shares, or the promise of issuing shares, has greatly increased in recent years. While this method of payment is occasionally used to purchase goods and other services, it is most commonly used to reward employees, particularly the directors and other managers of large and listed companies. We will, in this section, concentrate on this use of share-based payments but readers should be aware that the basic principles also apply to the use of this device for other purposes.

In general, share-based payments are used to encourage executives and other employees to strive to ensure that shareholder wealth is maximised and to encourage staff to remain with the company. Hence payment is often only triggered if a target related to the value of shares is achieved and is only payable if staff members serve for a specified minimum period.

²⁸ This is of no great moment as the contributions have to be disclosed under the terms of FRS 17.

²⁹ Letter dated 4 October 2002 from Mary Keegan, chairman of the ASB, to Sir David Tweedie, Chairman of the IASB: www.asb.org.uk.

Different types of share-based payment

Schemes vary greatly in terms of both their complexity and their generosity. Some of the main variants are described below but it should be noted that in practice a scheme may comprise variations of or combinations of these plans.³⁰ In particular the schemes vary depending upon:

- whether the employees are promised a cash payment based on the excess of the market value of the shares at a specified future date over a stated price, often called share appreciation rights (SARs), or whether they are given an option to acquire shares in the employing company at a stated price;
- the extent to which stated performance criteria have to be achieved if the employee is to be entitled to benefit from the scheme. Performance criteria may include movements in share prices, return on equity or earnings per share growth. Share option schemes that do not require the attainment of targets are called ‘plain vanilla’ share options while those that do require target achievement are called performance-vesting schemes.

Existing practice

Prior to the publication of FRED 31, the only significant guidance offered in the UK was through UITF Abstract 17, *Employee share schemes*, revised in October 2000.³¹ This required that, where share options are awarded to employees, a cost should be recognised in the financial statements. The minimum amount of this cost should be the difference between the fair value of the shares at the date of the grant and the amount of the exercise price, that is the consideration, if any, that the employees would be required to pay on exercise of the option. The Abstract takes the view that ‘normally, the fair value of the shares will be estimated to be the market value of the shares at that time’ (Para. 5) and this ‘intrinsic value’ is often very low or zero because, generally, the exercise price is equal to the market price at the date of the grant. The whole point of the scheme is, of course, to encourage executives to bring about a substantial increase in market value.

There is no guidance on share-based payments made to non-employees, other than the general requirements of FRS 4 that the issue of shares and warrants should be reported on the basis of the net proceeds received.

A major advance was the publication by the ASB of a Discussion Paper, *Share-based payments*, in July 2000, a document based on a discussion paper produced by a G4+1 working group. The main recommendation of these discussion papers was that where an entity obtains goods and services, including services from employees, and payment is in the form of shares or share options, the transaction should be measured at the fair value of the shares or options at the vesting date. The vesting date is the date upon which the other party (the employee) has performed all the services necessary to become unconditionally entitled to the shares or options.³²

³⁰ A more detailed description can be found in the ASB Discussion Paper, *Share-based payments*, issued in July 2002.

³¹ There was also UITF Abstract 13 *Accounting for ESOP Trusts*, which was concerned with the treatment of shares held on trust for employees in the period before they vested in the employees.

³² ASB Discussion Paper, *Share-based payments*, Para. 8.1.

Since in many cases the fair value of an option at the vesting date is considerably higher than its intrinsic value at the grant date, the adoption of this proposal would have resulted in a considerable impact on the reported operating profits of companies issuing such options (see p. 318).

FRED 31 *Share-based Payments*

FRED 31 builds on some, but not all, of the recommendations of the discussion papers and is based upon an IASB exposure draft ED 2 *Share-based Payments*, issued at the same time in November 2002. Like the discussion papers, FRED 31 proposes that the expense should be based on the fair value of the shares or options but differs in that it proposes that the fair value should be measured at the grant date rather than the vesting date:

The grant date being the date at which the entity and another party (including an employee) agree to a share-based payment arrangement, being when the entity and the counterparty have a shared understanding of the terms and conditions of the agreement.³³

We shall discuss the implications of the different dates later in this section but we should start by describing the ways in which the fair value of an option can be measured. There are a number of models that are used to value options, of which the best known is the Black–Scholes model. While this Black–Scholes model is referred to in the commentary section of the exposure draft, entities are free to use other models. Both the IASB and the ASB make it clear that the proposed standard should focus on principles rather than on prescribing extensive application guidance which ‘would be likely to become outdated’.³⁴ Any model would have to take into account variables such as the following:

- exercise price of the option;
- current market price of the share;
- volatility of the underlying shares;
- dividend yield;
- level of interest rates;
- time period during which the option can be exercised.

Equity-settled share-based payment transaction

Most employee share option schemes are based on share-based payments where ‘the entity receives goods or services as consideration for equity instruments (including shares or share options)’.³⁵

We will introduce the basic principles using one of the examples contained in Appendix B to FRED 31.

An entity grants 100 options to each of its 500 employees. Each grant is conditional on:

- the employee working for the entity for three years;
- the entity achieving an 18 per cent increase in its share price by the end of the three-year service period.

³³ FRED 31, p. 97.

³⁴ FRED 31, Para. BC 182.

³⁵ FRED 31, p. 96.

The entity estimates that the value of each option is Currency Units (CU) 15³⁶ before adjusting for the probability of staff leaving before the end of the period or for the probability that the target increase of 18 per cent will not be achieved.

Let us assume that the entity estimates that 20 per cent of its staff will not stay for the required three-year period and further that they will leave at a steady rate over the period; let us also assume that the entity estimates that the probability that the performance target will not be met is 0.85. On the basis of these, possibly heroic, assumptions the total fair value of the options at the grant date is given by the product of the estimated number of staff in post at the end of the period, the probability that the target will be achieved and the fair value of the options that are awarded to each individual:

$$500 \times 0.80 \times 0.85 \times \text{CU}15 \times 100 = \text{CU}510\,000$$

We also have to work out the expected number of years of service that will be supplied by the employees. Twenty per cent of the employees are expected to leave during the period and, as we are assuming that the departures will occur evenly over the period, we will expect that the 100 leavers will provide $100 \times 1.5 = 150$ years of service that together with the 1200 years of service from those who stay the course gives a total of 1350. Thus the estimated fair value of each unit (or year) of service is $\text{CU}510\,000/1350 = \text{CU}377.77$.

Readers will note the nature of the assumptions that have to be made in order to arrive at this figure. First, it is necessary to determine the fair value of each option, here CU15, using an option-pricing model. This is a difficult task. Next it is necessary to estimate the rate of staff turnover, the rate of which is likely to be affected by changes in general economic conditions as well as by the introduction of the share option scheme itself. It is also necessary to estimate the probability of the agreed target not being achieved and it is difficult to see how a substantial element of objectivity can be introduced into this process. The nature and magnitude of the estimates that have to be made provides strong ammunition for those who are opposing the implementation of the proposals.

Let us suppose that the entity actually receives 430 units (years) of service in year 1, 400 in year 2 and 375 in year 3. Then the expense that will be recognised in each of the three years is as given below.

		CU
Year 1	430 × CU 377.77	162 441
Year 2	400 × CU 377.77	151 108
Year 3	375 × CU 377.77	141 664
Total		455 213

The actual expense recognised is less than the original estimate of CU510 000 because fewer units of service were provided than had been estimated; if more units of service had been provided the total would have been greater.

Each year the profit and loss account would be debited and equity credited with the appropriate amount. The element of equity that would be credited would in some countries be described as 'other equity' but in the UK would probably be described as 'potential share options'.

We now come to the end of the vesting period. Let us first assume that the financial target of 18 per cent growth in the share price has been achieved so that the share options can be

³⁶ In this more international world the ASB now expresses monetary amounts as Currency Units (CUs).

exercised. Then, in respect of those options that are exercised, cash would be debited with the consideration, if any, and share capital credited. Similarly a transfer would be made between other equity (share options), and share capital and share premium, where appropriate, of the amount previously credited in respect of the options that are taken up.

What if the options are not taken up, either because the performance target is not met or because some employees do not avail themselves of the right to acquire the shares? The answer which is perhaps surprising, is nothing. The argument is that the service has been rendered and that the consideration for the service was the fair value of the options granted. The lapsing of the option does not represent a gain to the entity because there is no change in the entity's net assets. The lapsing of the option merely represents the transfer of one type of equity, share options, to another part of the equity interest and hence the Board believes that the only accounting entry that would be required is a movement within equity to reflect the fact that the options are no longer outstanding.³⁷

Had the Board adopted the discussion paper's proposal that the fair values should be calculated on their vesting day then it would have been necessary to make an estimate each year of the accrual based on the fair value of the shares or options at the year end. Consequently the charge for each year would be comprised of the charge for the services of the employees during the year together with a charge or credit reflecting changes in the previous accrual.³⁸ The Board rejected this approach, for the same reason as was advanced for not adjusting for cancelled options, that the changes to the accrual represent changes within equity and should not affect the profit and loss account.³⁹

Cash-settled share-based payment transactions

With these schemes, the employees are paid in cash but the amount of the payment depends on the change in the price of the entity's shares or other equity interests. Here the accrual at any one time is the best estimate, using an option-pricing model, that will have to be paid to the employees still eligible under the scheme. As such schemes involve a potential reduction in resources through the payment of cash, adjustments to accruals are dealt with through the profit and loss account.⁴⁰ However, the Board believes that users will find it relevant to know the extent to which the charge for the year has been affected by changes in the estimates of fair values so Para. 52(b) requires the disclosure of the portion of the expense that is attributable to the transaction being measured as a cash-settled rather than an equity-settled transaction.

Other aspects of FRED 31

We have in this section concentrated on the basic principles underlying FRED 31 but it is a long document which has to deal with more complex arrangements including repricing, cancellation of schemes, reload features and share-based transactions which involve a choice between cash and equity settlements. Readers who wish to pursue this subject in more depth are referred to FRED 31 itself.

³⁷ FRED 31, Paras 16 and BC 205.

³⁸ ASB Discussion Paper *Share-based payments*, Para. 8.4.

³⁹ FRED 31, Para. BC 99.

⁴⁰ An example of a cash-settled scheme is provided in Appendix C to FRED 31.

The response to the Discussion Paper and FRED 31

FRED 31 is one of the more controversial exposure drafts to be issued, for the adoption of its principles will have a mighty impact on the reported profits of those companies that make extensive use of share-based incentive schemes, and has had a significant impact on those companies which have adopted it on a voluntary basis. For example, had Microsoft applied the principles in its financial statements for the year ended 30 June 2001, its net income would have fallen by 29 per cent from \$7.7 billion to \$5.5 billion.⁴¹

The proposals set out in the discussion paper that an expense should be recognised received strong support from the UK investment community but others, especially companies whose profits would be seriously eroded, expressed strong opposition. The Finance Director of Logica, for example, said that if the proposals were to be implemented, it would make 'many companies think very hard if they want to be in Britain'.⁴² Similar differences in view are found in many other countries and, because of the vehemence of the opposition, it would be difficult for any country to issue a standard unilaterally. This is why the IASB sees this as a 'leadership project' which is designed to take political pressure off national standard setters. There are those who see the outcome of this particular battle as a major factor in establishing global accounting standards and believe that the credibility of the IASB will be severely dented if it is not able to impose this standard.⁴³

The IASB proposes to introduce a new standard for periods beginning on or after 1 January 2004 so it remains to be seen whether or not it is successful in this extremely controversial area.

Summary

We have in this chapter introduced a number of stratagems that have been adopted by standard setters, negatively, to minimise the possibility of abuse through the manipulation of figures and, positively, to reconfigure the financial statements in order to provide users with more relevant information that will, in particular, help them predict future results.

We saw how FRS 3 built on its predecessor SSAP 6 in outlawing reserve accounting by ensuring that, in general, income and expenditure is reflected in a profit and loss account or statement of total recognised gains and losses, rather than being taken directly to reserves. In addition, FRS 3 clarified the way in which the results of discontinued operations should be reported. This standard also plays an important role in attempting to achieve a move away from a fixation on the 'bottom line', the post-tax profit, to what has been termed an 'information set' approach whereby users are encouraged to adopt a broader perspective when interpreting financial statements. Thus FRS 3 introduced the concept of the statement of total recognised gains and losses that standard setters believe should be treated on a par with the profit and loss account. We also discussed the work that has been done to build on the foundations laid down by FRS 3.

The issues surrounding four of the topics covered in the chapter, segmental reporting, accounting for post balance sheet events, earnings per share and related party disclosures are

⁴¹ William A. Sahlom, 'Expensing Options Solves Nothing', *Harvard Business Review*, December 2002.

⁴² *Independent on Sunday*, 3 June 2001, p. B1.

⁴³ Ron Paterson, 'Biting the Bullet', *Accountancy*, January 2003.

more pragmatic than theoretical. While the last three of these are currently the subject of review, it is unlikely that fundamental changes will be made to existing standards. The same might also be said of segmental reporting, which is the only topic covered in the chapter that is not yet being actively pursued as part of the convergence programme.

The most controversial subject covered in the chapter is share-based payments. This, as we saw, involves a number of interesting issues concerned with distinguishing between items that should appear in the operating statements and those that would only involve movements within equity. We also noted that, for many entities, the introduction of the accounting treatment proposed in FRED 31 would have a significant impact on reported earnings and, not surprisingly, this has generated considerable opposition. The use of share-based payment undoubtedly has a cost which should be recognised in the financial statements and the issue of a standard on this subject will be a true test of the ability of the IASB to set global accounting standards in controversial areas of accounting.

Recommended reading

J. Coulton, 'Accounting for executive stock options: a case study in avoiding tough decisions' *Australian Accounting Review*, Vol. 12, No. 1, March 2002.

IATA (in association with KPMG) *Segmental Reporting*, Montreal, IATA, 2000.

S. Lin, 'The association between analysts' forecasts revisions and earning components: the evidence of FRS 3' *British Accounting Review*, Vol. 34, No. 1, 2002.

Excellent up-to-date and detailed reading on the subject matter of this chapter and on much of the contents of this book is provided by the most recent edition of:

UK and International GAAP, A. Wilson, M. Davies, M. Curtis and G. Wilkinson-Riddle (eds), Ernst & Young, Butterworths Tolley, London. At the time of writing, the latest edition is the 7th, published in 2001.

Questions

11.1 The introduction of FRS 3, *Reporting Financial Performance*, has resulted in a considerably expanded profit and loss account with related disclosures and a new primary statement. The standard is intended to be based on the 'all-inclusive' concept of income.

Requirements

(a) Discuss why FRS 3 was introduced and whether it has achieved its objectives. (7 marks)

(b) Describe how the standard has implemented the 'all-inclusive' concept of income. (3 marks)

ICAEW, Financial Reporting, November 1994 (10 marks)

11.2 Discuss whether the range of information provided by the implementation of FRS 3, *Reporting financial performance*, is helpful to users of published financial statements.

ICAEW, Financial Reporting, May 1998 (10 marks)

- 11.3** FRS 3, *Reporting financial performance*, significantly supplements the financial information required under statutory formats.

Requirements

- (a) Discuss the effect of the following disclosures on users' understanding of the financial performance of a limited company:
- (i) analysis of turnover down to operating profit between continuing operations, discontinued operations and acquisitions in the period;
 - (ii) statement of total recognised gains and losses; and
 - (iii) note of historical cost profits and losses. (13 marks)
- (b) Discuss how disaggregated data required by the disclosures in SSAP 25, *Segmental reporting*, assist users to analyse and interpret published financial information. (7 marks)

ICAEW, *Financial Reporting, June 2001*

(20 marks)

- 11.4** A Ltd is a company which specialises in the processing of canned beans and canned spaghetti for sale to retail shops. The canned beans are processed from beans bought in directly from UK farmers. The canned spaghetti is processed from pasta which is purchased from suppliers in Italy. Processing and canning take place at one of two factories in the United Kingdom, one factory dealing with beans and one with spaghetti. Each factory maintains separate financial statements in order to produce a monthly operating report for Head Office.

Once canned, the products are transferred to one of four distribution centres (two centres per factory). The distribution centres (which also maintain their own individual financial statements) are used to transfer the products to shops and supermarkets following orders for sales. The accounting year end of the company is 31 December.

On 30 November 1995, a decision was made to rationalise the business. Due to adverse exchange rate movements it was decided to discontinue the processing and sale of canned spaghetti, and concentrate exclusively on canned beans. The consequence of this decision was that the factory which processed pasta into spaghetti and one of the associated distribution centres would be sold, and the majority of the personnel employed at these locations made redundant. It was decided to commence running down the processing operations and the distribution operations in the factory and the distribution centre to be closed on 15 January 1996, with an expectation to complete the closure by 31 March 1996. Apart from carrying out extensive negotiations with relevant Trades Unions regarding redundancy packages, no other closure activities were to be commenced before 15 January 1996.

On 30 November 1995, A Ltd also decided to rationalise its distribution operation. The rationalisation included closing one of the four centres (as noted above) and redefining the areas covered by the remaining centres (so that the three remaining centres took on the distribution formerly carried out by the four centres, with the work relating only to baked beans). The timetable for the rationalisation of the distribution operation in the three remaining centres was identical to that for the closure of the factory and the fourth centre (rundown of spaghetti distribution and reallocation of beans distribution commencing 15 January 1996, rationalisation complete by 31 March 1996).

You are the Chief Accountant of A Ltd, and one of the directors has recently visited you to discuss the accounting treatment of the rationalisation. The director is unsure as to whether the rationalisation will have any impact on the financial statements for the year ended 31 December 1995 given that the programme did not actually commence until 15 January 1996. The director is aware that there is an accounting standard which deals with the issue of discontinued operations but is unaware of any relevant details. The 1995 financial statements are currently in the course of preparation and are expected to be formally approved by the directors at the April 1996 board meeting. For the purposes of this question, you should assume that today's date is 29 February 1996.

Requirements

Write a memorandum for the Board of Directors which:

- (a) explains how a discontinued operation is defined in FRS 3; (6 marks)
 (b) outlines the accounting treatment (if any) of the decision to close the factories and one of the distribution centres and to rationalise the operations of the remaining distribution centres, in the financial statements of A Ltd for the year ended 31 December 1995.

Your explanation should encompass the treatment in the balance sheet and profit and loss account and any additional information which is required in the notes to the financial statements. (14 marks)

CIMA, Financial Reporting, May 1996 (20 marks)

11.5 Crail plc has the following matters outstanding before finalising its published financial statements for the year ended 30 April 2002.

- (1) The company sold its European business operations, excluding the fixed assets, on 10 April 2002 at a profit of £500 000. The turnover and operating profit for the year ended 30 April 2002 relating to the European business amounted to £5 million and £100 000 respectively. The disposal of the fixed assets of the European business occurred on 10 May 2002 when a profit of £150 000 was realised. The European operations had been acquired in June 2001 as part of the acquisition of an unincorporated business.
- (2) The company changed its accounting policy for research and development expenditure from capitalisation of development expenditure under SSAP 13, *Accounting for research and development*, to writing off all expenditure as incurred. As at 30 April 2002 the company had £400 000 of development expenditure capitalised with movements from 30 April 2001 being:

	£1000
As at 1 May 2001	250
Expenditure in year	200
Amortisation in year	<u>(50)</u>
As at 30 April 2002	<u><u>400</u></u>

The company has not yet implemented the new policy.

- (3) The company revalued its land and buildings on 1 May 2001 to £5 million (land element – £1 million). The land and buildings were bought for £3 million (land element – £400 000) on 1 July 1997; the buildings had a total useful economic life of 50 years and there has been no change to this following the revaluation. It is company policy to:
- charge a full year's depreciation in the year of acquisition/revaluation;
 - transfer the realised element of the revaluation reserve to realised profits annually.

The revaluation has not yet been accounted for but depreciation has been charged in the year ended 30 April 2002 based on historic cost.

- (4) The company intends to pay an ordinary dividend of 10% of profits legally distributable.
 (5) The company had a total turnover of £25 million and total operating profit of £1 million for the year ended 30 April 2002 before any adjustments for the above items. The company had opening balances of:

	£1000
Profit and loss account	6000
Revaluation reserve	–
Share capital	2000

- (6) The taxation charge for the year ended 30 April 2002 is £350 000. No changes to this are required as a result of the above adjustments.

Requirement

Prepare the following disclosures for the financial statements of Crail plc for the year ended 30 April 2002:

- Profit and loss account (relevant extracts only)
- Statement of total recognised gains and losses
- Note of historical cost profits and losses
- Reconciliation of movement in shareholders' funds
- Movement on reserves disclosure note.

ICAEW, *Financial Reporting, June 2002*

(20 marks)

11.6 Glamis plc manufactures, distributes and retails glassware. The following matters relate to its financial statements for the year ended 31 July 1998:

- (1) On 25 June 1998, one of the company's factories sustained damage from a freak storm. The cost of repairs in July 1998 was £500 000 and this has been provided for in the financial statements. The company's insurance does not cover this repair.
- (2) The company disposed of a fixed asset for £1 million in June 1998. The asset cost £850 000 in August 1994 and had an expected life of five years. The asset was revalued to £900 000 in the financial statements on 1 August 1996; no change to its total useful economic life was recommended. The company does not charge depreciation in the year of disposal of an asset and has based the profit on disposal in the profit and loss account on the carrying value of the asset.
- (3) The board of directors decided to close the company's retailing division on the basis of a formal plan submitted by the sales director. The company had accepted a firm offer of £3 million for the retail premises by 31 July 1998. The net book value of the premises was £2 million. Half of the staff involved in the retailing division were made redundant by 31 July 1998 at a cost of £500 000; the remaining staff were redeployed and retained at a cost of £200 000. All these transactions have been included in the financial statements.
- (4) The directors decided to change the accounting treatment of development costs to immediate write-off against profit as costs are incurred. This change has not yet been reflected in the draft financial statements. The balance on the development costs account at 31 July 1998 was £250 000 of which £200 000 was incurred by 31 July 1997.

The company's draft summarised profit and loss account shows:

	£000
Turnover	5500
Cost of sales	<u>(3100)</u>
Gross profit	2400
Distribution costs	(1100)
Administrative expenses	<u>(500)</u>
Profit before taxation	800
Taxation	<u>(240)</u>
Profit after taxation	560
Dividends	<u>(100)</u>
	<u><u>460</u></u>

Opening shareholders' funds as on 1 August 1997 were £1.2 million, as previously reported.

Requirements

- (a) Advise the board of directors of Glamis plc on the most appropriate accounting treatment and disclosure for each of the above matters, preparing all necessary calculations. You should refer to relevant accounting standards and legislation as appropriate. (10 marks)

Note: You are not required to prepare extracts of the financial statements.

- (b) Prepare the following extracts of the financial statements for Glamis plc:
- (i) Statement of total recognised gains and losses
 - (ii) Note of historical cost profit and losses
 - (iii) Reconciliation of movements on shareholders' funds. (9 marks)

Note: You should provide comparative figures as far as you can from the information available.

ICAEW, *Financial Reporting, September 1998* (19 marks)

- 11.7** The Accounting Standards Board has published a Discussion Paper, *Reporting Financial Performance: Proposals for Change*. The proposals in the Discussion Paper build upon the strengths of, and are a progression from FRS 3, *Reporting Financial Performance*. It proposes that a single performance statement should replace the profit and loss account and the Statement of Total Recognised Gains and Losses, effectively combining them in one statement. The paper also takes the view that gains and losses should be reported only once and in the period when they arise, and should not be reported again in another component of the financial statements at a later date, a practice which is sometimes called 'recycling'.

Required:

- (a) (i) Explain the reasons for presenting financial performance in one statement rather than two or more statements; (8 marks)
- (ii) Discuss the views for and against the recycling of gains and losses in the financial statements. (6 marks)
- (b) Describe how the following items are dealt with under current Financial Reporting Standards, and how their treatment would change if the Discussion Paper were adopted:
- (i) Gains and losses on the disposal of fixed assets; (4 marks)
 - (ii) Revaluation gains and losses on fixed assets; (4 marks)
 - (ii) Foreign currency translation adjustments arising on the net investment in foreign operations. (3 marks)

ACCA, *Financial Reporting Environment (UK Stream), December 2000* (25 marks)

- 11.8** Travis plc is a large grocery retailing and wholesaling organisation. It is presently drawing up its financial statements for the year ended 31 October 1993 and, mindful of the requirements of SSAP 25, has drafted the following segmental report:

Segment information

	Turnover		Profit before tax		Operating net assets	
	31.10.93	31.10.92	31.10.93	31.10.92	31.10.93	31.10.92
	£m	£m	£m	£m	£m	£m
By category						
Retailing						
Food	5650	6126	300	295	2925	2964
Drinks	1951	2047	219	136	987	917
Consumables	115	106	8	5	86	82
Wholesaling						
Warehousing	3843	3651	391	382	1560	1490
	<u>11559</u>	<u>11930</u>	<u>918</u>	<u>818</u>	<u>5558</u>	<u>5453</u>
By activity						
Retailing						
Hypermarkets	6235	6608	465	314	3120	3040
Large shops	545	534	43	40	560	538
Small shops	936	1137	19	82	318	385
Wholesaling						
Warehousing	3843	3651	391	382	1560	1490
	<u>11559</u>	<u>11930</u>	<u>918</u>	<u>818</u>	<u>5558</u>	<u>5453</u>

Notes

Head office and service costs of £53 million (1992: £51 million) have been allocated according to the relative contribution of each segment to the total of continuing operations.

The group's borrowing requirements are centrally managed and so interest expense of £475 million (1992: £415 million) has been apportioned on the basis of average net assets for each segment.

Operating net assets represent the group's net assets adjusted to exclude interest bearing operating assets and liabilities.

Businesses discontinued during the year contributed £450 million (1992: £850 million) to turnover and £38 million (1992: £68 million) to profit before tax.

Requirements

- (a) Discuss the objectives of segmental reporting in the context of each of the following user groups of financial statements:
- (i) the shareholder group
 - (ii) the investment analyst group
 - (iii) the lender/creditor group
 - (iv) Government. (10 marks)
- (b) Critically assess the presentation of Travis plc's draft 'Segment information' report, considering in particular its helpfulness to users of financial statements and its compliance with the requirements of SSAP 25. Outline any ways in which the information might be presented more effectively or in which the treatment of items might be improved. (11 marks)

ICAEW, *Financial Accounting 2, December 1993*

(21 marks)

- 11.9** Spreader plc is a UK parent company with a number of wholly-owned subsidiaries in the USA and Europe. Extracts from the consolidated financial statements of the group for the year ended 30 April 1997 are given below.

<i>Profit and loss account – year ended 30 April</i>		1997	1996
		£000	£000
Turnover	(Note 1)	50 000	48 000
Cost of sales		(25 000)	(22 000)
Gross profit		25 000	26 000
Other operating expenditure		(15 000)	(14 200)
Operating profit		10 000	11 800
Interest payable		(1 000)	(900)
Profit before taxation	(Note 2)	9 000	10 900
Taxation		(2 800)	(3 600)
Profit after taxation		6 200	7 300
Dividend		(3 000)	(3 200)
Retained profit		3 200	4 100

Note 1 Analysis of turnover for the year by geographical segment

	UK		US		Rest of Europe		Total	
	1997	1996	1997	1996	1997	1996	1997	1996
	£000	£000	£000	£000	£000	£000	£000	£000
Total sales	15 000	20 000	10 000	8 000	30 000	25 000	55 000	53 000
Inter-segment sales	(2 000)	(2 500)	(1 000)	(500)	(2 000)	(2 000)	(5 000)	(5 000)
Sales to third parties	13 000	17 500	9 000	7 500	28 000	23 000	50 000	48 000

Note 2 Analysis of profit before tax for the year by geographical segment

	UK		US		Rest of Europe		Total	
	1997	1996	1997	1996	1997	1996	1997	1996
	£000	£000	£000	£000	£000	£000	£000	£000
Segment profit	3 000	6 000	1 500	1 200	6 000	5 000	10 500	12 200
Common costs							(500)	(400)
Operating profit							10 000	11 800
Interest payable							(1 000)	(900)
Profit before taxation							9 000	10 900

Note 3 Analysis of net assets at end of year by geographical segment

	UK		US		Rest of Europe		Total	
	1997	1996	1997	1996	1997	1996	1997	1996
	£000	£000	£000	£000	£000	£000	£000	£000
Segment net assets	15 000	13 500	6 000	5 000	20 000	20 000	41 000	38 500
Unallocated assets							2 000	1 800
Total net assets							43 000	40 300

Requirements

In your capacity as chief accountant of Spreader plc,

- prepare a report for the board of directors of the company which analyses the results of the group for the year ended 30 April 1997; (21 marks)
- explain why the segmental data which has been included in the extracts may need to be interpreted with caution. (4 marks)

CIMA, Financial Reporting, May 1997

(25 marks)

- 11.10** (a) For enterprises that are engaged in different businesses with differing risks and opportunities, the usefulness of financial information concerning these enterprises is greatly enhanced if it is supplemented by information on individual business segments. It is recognised that there are two main approaches to segmental reporting. The risk and returns' approach where segments are identified on the basis of different 'risks and returns arising from different lines of business and geographical areas, and the 'managerial' approach whereby segments are identified corresponding to the enterprises' internal organisation structure.

Required

- (i) Explain why the information content of financial statements is improved by the inclusion of segmental data on individual business segments. (5 marks)
- (ii) Discuss the advantages and disadvantages of analysing segmental data using the 'risk and returns' approach (4 marks)
the 'managerial' approach. (3 marks)
- (b) AZ, a public limited company, operates in the global marketplace.
- (i) The major revenue-earning asset is a fleet of aircraft which are registered in the UK and its other main source of revenue comes from the sale of holidays. The directors are unsure as to how business segments are identified. (3 marks)
- (ii) The company also owns a small aircraft manufacturing plant which supplies aircraft to its domestic airline and to third parties. The preferred method for determining transfer prices for these aircraft between the group companies is market price, but where the aircraft is of a specialised nature with no equivalent market price the companies fix the price by negotiation. (2 marks)
- (iii) The company has incurred an exceptional loss on the sale of several aircraft to a foreign government. This loss occurred due to a fixed price contract signed several years ago for the sale of secondhand aircraft and resulted through the fluctuation of the exchange rates between the two countries. (3 marks)
- (iv) During the year the company discontinued its holiday business due to competition in the sector. (2 marks)
- (v) The company owns 40% of the ordinary shares of Eurocat Ltd, a specialist aircraft engine producer with operations in China and Russia. The investment is accounted for by the equity method and it is proposed to exclude the company's results from segment assets and revenue. (3 marks)

Required

Discuss the implications of each of the above points for the determination of the segmental information required to be prepared and disclosed under SSAP 25 *Segmental Reporting* and FRS 3 *Reporting Financial Performance*.

Please note that the mark allocation is shown after each paragraph in part (b).

ACCA, *Financial Reporting Environment (UK Stream)*, June 1999 (25 marks)

- 11.11** You are the Management Accountant of Global plc. Global plc has operations in a number of different areas of the world and presents segmental information on a geographical basis in accordance with SSAP 25 *Segmental reporting*. The segmental information for the year ended 30 June 2002 is given below:

	<i>Europe</i>		<i>America</i>		<i>Africa</i>		<i>Group</i>	
	2002	2001	2002	2001	2002	2001	2002	2001
	£m	£m	£m	£m	£m	£m	£m	£m
TURNOVER								
Turnover by destination:								
Sales to third parties	<u>700</u>	<u>680</u>	<u>600</u>	<u>550</u>	<u>400</u>	<u>200</u>	<u>1700</u>	<u>1430</u>
Turnover by origin:								
Total sales	720	685	610	560	440	205	1770	1450
Inter-segment sales	<u>(20)</u>	<u>(5)</u>	<u>(10)</u>	<u>(10)</u>	<u>(40)</u>	<u>(5)</u>	<u>(70)</u>	<u>(20)</u>
Sales to third parties	<u>700</u>	<u>680</u>	<u>600</u>	<u>550</u>	<u>400</u>	<u>200</u>	<u>1700</u>	<u>1430</u>
PROFIT BEFORE TAXATION								
Segment profit 1 (loss)	<u>70</u>	<u>69</u>	<u>990</u>	<u>90</u>	<u>(20)</u>	<u>(40)</u>	140	119
Common costs							<u>(25)</u>	<u>(20)</u>
Operating profit							115	99
Net interest							<u>(18)</u>	<u>(15)</u>
							97	84
Group share of associates' profit before taxation	<u>10</u>	<u>9</u>	<u>12</u>	<u>5</u>	<u>–</u>	<u>–</u>	<u>22</u>	<u>14</u>
Group profit before taxation							<u>119</u>	<u>98</u>
NET ASSETS								
Segment net assets	<u>350</u>	<u>320</u>	<u>360</u>	<u>330</u>	<u>200</u>	<u>180</u>	910	830
Unallocated assets							<u>120</u>	<u>100</u>
							1030	930
Group share of net assets of associates	<u>55</u>	<u>52</u>	<u>36</u>	<u>30</u>	<u>–</u>	<u>–</u>	<u>91</u>	<u>82</u>
Total net assets							<u>1121</u>	<u>1012</u>

Your Managing Director has reviewed the segmental information above and has expressed concerns about the performance of Global plc. He is particularly concerned about the fact that the Africa segment has been making losses ever since the initial investment in 2000. He wonders whether operations in Africa should be discontinued, given the consistently poor results.

Required

Prepare a report for the Managing Director of Global plc that analyses the performance of the three geographical segments of the business, based on the data that has been provided. The report can take any form you wish, but you should specifically refer to any reservations you may have regarding the use of the segmental data for analysis purposes.

CIMA, *Financial Reporting – UK Accounting Standards, November 2002* (20 marks)

- 11.12** FRS 3, *Reporting Financial Performance*, requires that earnings per share should be calculated on the profit after tax, minority interest and extraordinary items. FRS 3 permits an additional measure of earnings per share to be disclosed provided it is presented on a consistent basis over time and reconciled to the amount required by the standard. There should also be an explanation of the reasons for calculating the additional version.

As a result, there is no longer a unique measure of performance. Is this a good thing and what problems might this give preparers and users of financial statements?

ICAEW, *Financial Accounting 2*, July 1994

(12 marks)

- 11.13** A plc is a company which is listed on the UK Stock Exchange. Your client, Mr B, currently owns 300 shares in A plc. Mr B has recently received the published financial statements of A plc for the year ended 30 September 1998. Extracts from these published financial statements, and other relevant information, are given below. Mr B is confused by the statements. He is unsure how the performance of the company during the year will affect the market value of his shares, but is aware that the published earnings per share (EPS) is a statistic which is often used by analysts in assessing the performance of listed companies.

Profit and loss accounts – year ended 30 September

	1998	1997
	£ million	£ million
Turnover	10 000	8 500
Cost of sales	<u>(6 300)</u>	<u>(5 100)</u>
Gross profit	3 700	3 400
Other operating expenses	<u>(1 900)</u>	<u>(1 800)</u>
Operating profit	1 800	1 600
Interest payable	<u>(300)</u>	<u>(320)</u>
Profit before taxation	1 500	1 280
Taxation	<u>(470)</u>	<u>(400)</u>
Profit after taxation	1 030	880
Equity dividend	<u>(800)</u>	<u>(500)</u>
Retained profit	<u>230</u>	<u>380</u>

Balance sheets at 30 September

	1998		1997	
	£ million	£ million	£ million	£ million
<i>Fixed assets</i>				
Intangible assets	3000		–	
Tangible assets	<u>4000</u>		<u>3700</u>	
		7000		3700
<i>Current assets</i>				
Stocks	1300		1000	
Debtors	1500		1200	
Cash in hand and at bank	<u>100</u>		<u>90</u>	
	<u>2900</u>		<u>2290</u>	

	1998		1997	
	£ million	£ million	£ million	£ million
<i>Current liabilities</i>				
Trade creditors	900		700	
Taxation	500		420	
Proposed dividend	800		500	
Bank overdraft	600		700	
	<u>2800</u>		<u>2320</u>	
<i>Net current assets</i>		<u>100</u>		<u>(30)</u>
<i>Total assets less current liabilities</i>		7100		3670
Creditors: amounts falling due after more than one year:				
Loan stock		<u>(2000)</u>		<u>(2000)</u>
		<u>5100</u>		<u>1670</u>
<i>Capital and reserves</i>				
Called-up share capital		1500		500
Share premium account		2700		500
Profit and loss account		900		670
		<u>5100</u>		<u>1670</u>

Information regarding share capital

The called-up share capital of the company comprises £1 equity shares only. On 1 April 1998, the company made a rights issue to existing shareholders of two new shares for every one share held, at a price of £3.30 per share, paying issue costs of £100 000. The market price of the shares immediately before the rights issue was £3.50 per share. No changes took place in the equity capital of A plc in the year ended 30 September 1997.

Requirements

- Compute the EPS figures (current year plus comparative) that will be included in the published financial statements of A plc for the year ended 30 September 1998. (5 marks)
- Using the extracts with which you have been provided, write a short report to Mr B which identifies the key factors which have led to the change in the EPS of A plc since the year ended 30 September 1997. (10 marks)
- Comment on the relevance of the EPS statistic to a shareholder like Mr B who is concerned about the market value of his shares. (5 marks)

CIMA, *Financial Reporting*, November 1998

(20 marks)

- 11.14** Earnings per share is one of the most quoted statistics in financial analysis, coming into prominence because of the widespread use of the price earnings ratio as an investment decision making yardstick. In 1972 SSAP 3 *Earnings per share*, was issued and revised in 1974, and the standard as amended was operating reasonably effectively. In fact the Accounting Standards Board (ASB) has stated that a review of earnings per share would not normally have been given priority at this stage of the Board's programme. However, in June 1997 FRED 16 *Earnings per share*, was issued which proposed amendments to SSAP 3 and subsequently in October 1998 FRS 14 *Earnings per share* was published.

Required

- (a) (i) Describe the main changes to SSAP 3 which have occurred as a result of FRS 14 and the main reasons for those changes. (6 marks)
- (ii) Explain why there is a need to disclose diluted earnings per share in financial statements. (5 marks)
- (b) The following financial statement extracts for the year ending 31 May 1999 relate to Mayes, a public limited company.

	£000	£000
Operating profit		
Continuing operations	26 700	
Discontinued operations	<u>(1 120)</u>	
		25 580
Continuing operations		
Profit on disposal of tangible fixed assets		2 500
Discontinued operations		
(Loss) on sale of operations		<u>(5 080)</u>
		23 000
Interest payable		<u>(2 100)</u>
Profit on ordinary activities before taxation		20 900
Tax on profit on ordinary activities		<u>(7 500)</u>
Profit on ordinary activities after tax		13 400
Minority interest – equity		<u>(540)</u>
Profit attributable to members of parent company		12 860
Dividends:		
Preference dividend on non-equity shares	210	
Ordinary dividend on equity shares	<u>300</u>	
		(510)
Other appropriations – non-equity shares (note iii)		(80)
Retained profit for year		<u>12 270</u>
<i>Capital as at 31 May 1999.</i>		£000
Allotted, called up and fully paid ordinary shares of £1 each		12 500
7% convertible cumulative redeemable preference shares of £1		<u>3 000</u>
		<u>15 500</u>

Additional Information

- (i) On 1 January 1999, 3.6 million ordinary shares were issued at £2.50 in consideration of the acquisition of June Ltd for £9 million. These shares do not rank for dividend in the current period. Additionally the company purchased and cancelled £24 million of its own £1 ordinary shares on 1 April 1999. On 1 July 1999, the company made a bonus issue of 1 for 5 ordinary shares before the financial statements were issued for the year ended 31 May 1999.
- (ii) The company has a share option scheme under which certain directors can subscribe for the company's shares. The following details relate to the scheme.

Options outstanding 31 May 1998:

- (i) 1.2 million ordinary shares at £2 each
- (ii) 2 million ordinary shares at £3 each

both sets of options are exercisable before 31 May 2000.

Options granted during year 31 May 1999

- (i) One million ordinary shares at £4 each exercisable before 31 May 2002, granted 1 June 1998.

During the year to 31 May 1999, the options relating to the 1.2 million ordinary shares (at a price of £2) were exercised on 1 March 1999.

The average fair value of one ordinary share during the year was £5.

- (iii) The 7% convertible cumulative redeemable preference shares are convertible at the option of the shareholder or the company on 1 July 2000, 2001, 2002 on the basis of two ordinary shares for every three preference shares. The preference share dividends are not in arrears. The shares are redeemable at the option of the shareholder on 1 July 2000, 2001, 2002 at £1.50 per share. The 'other appropriations – non-equity shares' item charged against the profits relates to the amortisation of the redemption premium and issue costs on the preference shares.
- (iv) Mayes issued £6 million of 6% convertible bonds on 1 June 1998 to finance the acquisition of Space Ltd. Each bond is convertible into 2 ordinary shares of £1. Assume a corporation tax rate of 35%.
- (v) The interest payable relates entirely to continuing operations and the taxation charge relating to discontinued operations is assessed at £100 000 despite the accounting losses. The loss on discontinued operations relating to the minority interest is £600 000.

Requirement

Calculate the basic and diluted earnings per share for the year ended 31 May 1999 for Mayes plc utilising FRS 14 *Earnings per share*. (14 marks)

(Candidates should show a calculation of whether potential ordinary shares are dilutive or anti-dilutive.)

ACCA, *Financial Reporting Environment (UK Stream)*, June 1999 (25 marks)

11.15 Earnit plc is a listed company. The issued share capital of the company at 1 April 1999 was as follows:

- 500 million equity shares of 50p each.
- 100 million £1 non-equity shares, redeemable at a premium on 31 March 2004. The effective finance cost of these shares for Earnit plc is 10% per annum. The carrying value of the non-equity shares in the financial statements at 31 March 1999 was £110 million.

Extracts from the consolidated profit and loss account of Earnit plc for the year ended 31 March 2000 showed:

	£ million
Turnover	250
Cost of sales	<u>(130)</u>
Gross profit	120
Other operating expenses	<u>(40)</u>
Operating profit	80
Exceptional gain	10
Interest payable	<u>(25)</u>
Profit before taxation	65
Taxation	<u>(20)</u>
Profit after taxation	45
Appropriations of profit (see note)	<u>(26)</u>
Retained profit	<u><u>19</u></u>

Note – appropriations of profit:

● to non-equity shareholders	11
● to equity shareholders	<u>15</u>
	<u><u>26</u></u>

The company has a share option scheme in operation. The terms of the option are that option holders are permitted to purchase 1 equity share for every option held at a price of £1.50 per share. At 1 April 1999, 100 million share options were in issue. On 1 October 1999, the holders of 50 million options exercised their option to purchase, and 70 million new options were issued on the same terms as the existing options. During the year ended 31 March 2000, the average market price of an equity share in Earnit plc was £2.00.

There were no changes to the number of shares or share options outstanding during the year ended 31 March 2000 other than as noted in the previous paragraph.

Requirements

(a) Compute the basic and diluted earnings per share of Earnit plc for the year ended 31 March 2000. Comparative figures are NOT required. (10 marks)

(b) Explain to a holder of equity shares in Earnit plc the usefulness of both of the figures you have calculated in part (a). (10 marks)

CIMA, Financial Reporting, May 2000 (20 marks)

- 11.16** (a) The Accounting Standards Board (ASB) believes that undue emphasis is placed on Earnings per share (EPS) and that this leads to simplistic interpretation of financial performance. Many chief executives believe that their share price does not reflect the value of their company and yet are pre-occupied with earnings based ratios. It appears that if chief executives shared the views of the ASB then they may disclose more meaningful information than EPS to the market, which may then reduce the reporting gap and lead to higher share valuations. The 'reporting gap' can be said to be the difference between the information required by the stock market in order to evaluate the performance of a company and the actual information disclosed.

Required

- (i) Discuss the potential problems of placing undue emphasis on the Earnings per share figure. (5 marks)

- (ii) Discuss the nature of the 'reporting gap' and how the 'gap' might be eliminated. (5 marks)
- (b) Company X has a complex capital structure. The following information relates to the company for the year ending 31 May 2001:

- (i) The net profit of the company for the period attributable to the preference and ordinary shareholders of the parent company was £14.6 million. Of this amount the net profit attributable to discontinued operations was £3.3 million.

The following details relate to the capital of the company:

	million
(ii) Ordinary shares of £1 in issue at 1 June 2000	6.0
Ordinary shares of £1 issued 1 September 2000 at full market price.	1.2

The average market price of the shares for the year ending 31 May 2001 was £10 and the closing market price of the shares on 31 May 2001 was £11. On 1 January 2001, 300 000 partly paid ordinary shares of £1 were issued. They were issued at £8 per share with £4 payable on 1 January 2001 and £4 payable on 1 January 2002. Dividend participation was 50 per cent until fully paid.

- (iii) Convertible loan stock of £20 million at an interest rate of 5% per annum was issued at par on 1 April 2000. Half a year's interest is payable on 30 September and 31 March each year. Each £1000 of loan stock is convertible at the holder's option into 30 ordinary shares at any time. £5 million of loan stock was converted on 1 April 2001 when the market price of the shares was £34 per share.
- (iv) £1 million of convertible preference shares of £1 were issued in the year to 31 May 1998. Dividends are paid half yearly on 30 November and 31 May at a rate of 6% per annum. The preference shares are convertible into ordinary shares at the option of the preference shareholder on the basis of two preference shares for each ordinary share issued. Holders of 600 000 preference shares converted them into ordinary shares on 1 December 2000.
- (v) Warrants to buy 600 000 ordinary shares at £6.60 per share were issued on 1 January 2001. The warrants expire in five years' time. All the warrants were exercised on 30 June 2001. The financial statements were approved on 1 August 2001.
- (vi) The rate of taxation is to be taken as 30%.

Required

Calculate the basic and diluted Earnings per share for X for the year ended 31 May 2001 in accordance with FRS 14 *Earnings per share*. (15 marks)

ACCA, *Financial Reporting Environment (UK Stream)*, June 2001 (25 marks)

- 11.17** Related party relationships and transactions are a normal feature of business. Enterprises often carry on their business activities through subsidiaries and associates and it is inevitable that transactions will occur between group companies. Until relatively recently the disclosure of related party relationships and transactions has been regarded as an area which has a relatively low priority. However, recent financial scandals have emphasised the importance of an accounting standard in this area.

Required

- (a) (i) Explain why the disclosure of related party relationships and transactions is an important issue. (6 marks)
- (ii) Discuss the view that small companies should be exempt from the disclosure of related party relationships and transactions on the grounds of their size. (4 marks)
- (b) Discuss whether the following events would require disclosure in the financial statements of the RP Group plc under FRS 8 Related Party Disclosures.
RP Group plc, merchant bankers, has a number of subsidiaries, associates and joint ventures in its group structure. During the financial year to 31 October 1999, the following events occurred:
- (i) The company agreed to finance a management buyout of a group company, AB, a limited company. In addition to providing loan finance, the company has retained a twenty-five per cent equity holding in the company and has a main board director on the board of AB. RP received management fees, interest payments and dividends from AB. (6 marks)
- (ii) On 1 July 1999, RP sold a wholly owned subsidiary, X a limited company, to Z, a public limited company. During the year RP supplied X with second-hand office equipment and X leased its factory from RP. The transactions were all contracted for at market rates. (4 marks)
- (iii) The pension scheme of the group is managed by another merchant bank. An investment manager of the group pension scheme is also a non-executive director of the RP Group and received an annual fee for his services of £25 000 which is not material in the group context. The company pays £16m per annum into the scheme and occasionally transfers assets into the scheme. In 1999, fixed assets of £10m were transferred into the scheme and a recharge of administrative costs of £3m was made. (5 marks)

ACCA, *Financial Reporting Environment (UK Stream)*, December 1999 (25 marks)

- 11.18** (a) Explain the purpose of FRS 8, *Related party disclosures*, its relevance to users of published financial information and the main differences to international accounting standards. (6 marks)
- (b) The directors of Sidlaw Ltd have requested your advice on the appropriate accounting disclosures for the following:
- (1) On 1 February 2001, Sidlaw Ltd purchased 75% of the ordinary share capital of Errol Ltd. Sidlaw Ltd sells £250 000 worth of goods to Errol Ltd every month and has done so for many years.
- (2) Sidlaw Ltd has a self-managed pension fund for its employees and pays £4 million per annum into the fund. Sidlaw Ltd's directors also act as fund managers for which Sidlaw Ltd makes no charge to the pension fund.
- (3) Mr Muir owns and controls Sidlaw Ltd and Kirric Ltd and has influence, but not control, over Glamis Ltd. All three companies buy and sell goods to each other but are not part of the same group.

Requirement

Advise the directors of Sidlaw Ltd on the appropriate accounting disclosures required under FRS 8, *Related party disclosures*, for all affected companies, providing brief reasons for your recommendations. (7 marks)

ICAEW, *Financial Reporting*, June 2001 (13 marks)

11.19 Newcars plc is a vehicle dealership; it sells both new and good quality second-hand cars. The company is large and has a large number of shareholders. The only large block of shares is held by Arthur, who owns 25% of Newcars plc. Arthur is a member of Newcars plc's board of directors and he takes a keen interest in the day-to-day management of the company.

Arthur also owns 25% of Oldcars plc. Oldcars plc sells inexpensive second-hand cars which tend to be either relatively old or have a high mileage. Arthur is also a member of the board of directors of Oldcars plc.

Apart from Arthur, Newcars plc and Oldcars plc have no shareholders in common. The only thing that they have in common, apart from Arthur's interest in each, is that Newcars plc sells a large number of cars to Oldcars plc. This usually happens when a customer of Newcars plc has traded in a car that is too old to be sold from Newcars plc's showroom. Most of these cars are immediately resold to Oldcars plc and go into Oldcars plc's normal trading stock. These sales account for approximately 5% of Newcars plc's turnover. Oldcars plc acquires approximately 20% of its cars from Newcars plc.

Required

- (a) Explain whether Newcars plc and Oldcars plc are related parties in terms of the requirements of FRS 8, *Related party disclosures*. List any additional information that you would require before making a final decision. (7 marks)
- (b) Assuming that Newcars plc and Oldcars plc are related parties, describe the related parties' disclosures that would have to be made in the companies' financial statements in respect of the sale and purchase of cars between the two companies. (6 marks)
- (c) Explain why it is necessary to disclose such information in respect of transactions involving related parties. (7 marks)

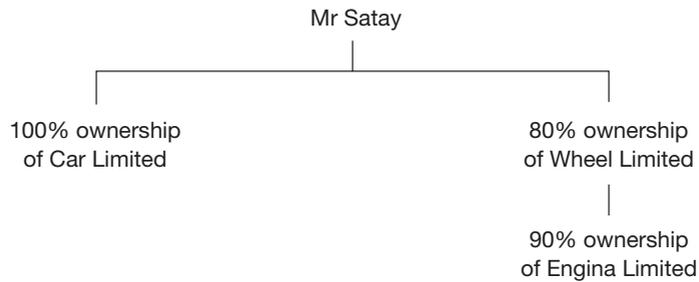
CIMA, Financial Accounting – UK Accounting Standards, May 2001 (20 marks)

11.20 Engina, a foreign company, has approached a partner in your firm to assist in obtaining a Stock Exchange listing for the company. Engina is registered in a country where transactions between related parties are considered to be normal but where such transactions are not disclosed. The directors of Engina are reluctant to disclose the nature of their related party transactions as they feel that although they are a normal feature of business in their part of the world, it could cause significant problems politically and culturally to disclose such transactions.

The partner in your firm has requested a list of all transactions with parties connected with the company and the directors of Engina have produced the following summary:

- (a) Every month, Engina sells £50 000 of goods per month to Mr Satay, the financial director. The financial director has set up a small retailing business for his son and the goods are purchased at cost price for him. The annual turnover of Engina is £300 million. Additionally Mr Satay has purchased his company car from the company for £45 000 (market value £80 000). The director, Mr Satay, owns directly 10% of the shares in the company and earns a salary of £500 000 a year, and has a personal fortune of many millions of pounds.
- (b) A hotel property had been sold to a brother of Mr Soy, the Managing Director of Engina, for £4 million (net of selling cost of £0.2 million). The market value of the property was £4.3 million but in the overseas country, property prices were falling rapidly. The carrying value of the hotel was £5 million and its value in use was £3.6 million. There was an over supply of hotel accommodation due to government subsidies in an attempt to encourage hotel development and the tourist industry.

(c) Mr Satay owns several companies and the structure of the group is as follows:



Engina earns 60% of its profit from transactions with Car and 40% of its profit from transactions with Wheel.

Required

Write a report to the directors of Engina setting out the reasons why it is important to disclose related party transactions and the nature of any disclosure required for the above transactions under the UK regulatory system before a Stock Exchange quotation can be obtained. (25 marks)

The mark allocation will be as follows:

	Marks
Style/layout of report	4
Reasons	8
Transaction (a)	4
(b)	5
(c)	4
	<u>25</u>

ACCA, Advanced Corporate Reporting, Pilot Paper (2002)