Accounting Standards Board october 1992 frs 3

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# Reporting financial performance

FINANCIAL REPORTING STANDARD

ACCOUNTING STANDARDS BOARD

*Financial Reporting Standard No. 3 - 'Reporting Financial Performance' is issued by the Accounting Standards Board in respect of its application in the United Kingdom and by the Institute of Chartered Accountants in Ireland in respect of its application in the Republic of Ireland.*

# 3

# Reporting financial performance

FINANCIAL REPORTING
STANDARD

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## SUMMARY

a Financial Reporting Standard No. 3 'Reporting Financial Performance' (the FRS) introduces: changes to the format of the profit and loss account; a note of historical cost profits and losses; a statement of total recognised gains and losses; and a reconciliation of movements in shareholders' funds. The FRS supersedes Statement of Standard Accounting Practice No. 6 (Revised) 'Extraordinary items and prior year adjustments' (SSAP 6), amends SSAP 3 'Earnings per share' and makes consequential changes to a number of other accounting standards.

b A layered format is to be used for the profit and loss account to highlight a number of important components of financial performance:

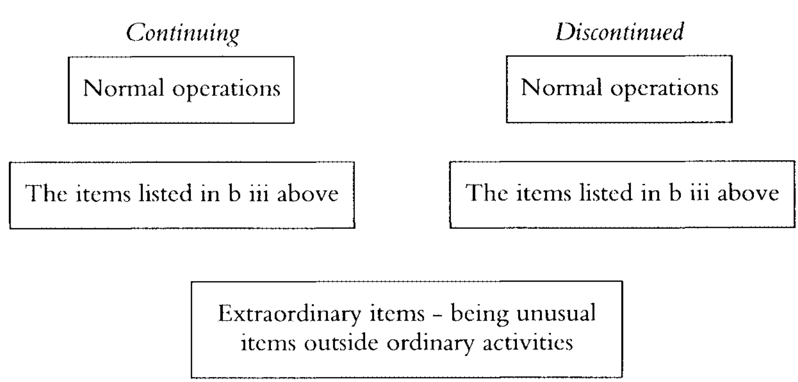
i results of continuing operations (including the results of acquisitions);

ii results of discontinued operations;

iii profits or losses on the sale or termination of an operation, costs of a fundamental reorganisation or restructuring and profits or losses on the disposal of fixed assets; and

iv extraordinary items.

The thrust of this approach can be illustrated diagramatically as follows:



c In presenting the profit and loss account the following requirements should be observed:

i The analysis between continuing operations, acquisitions (as a component of continuing operations) and discontinued operations should be disclosed to the level of operating profit (which for non-financial reporting entities is normally profit before income from shares in group undertakings). The analysis of turnover and operating profit is the minimum disclosure required in this respect on the face of the profit and loss account.

ii All exceptional items, other than those in iii below, should be included under the statutory format headings to which they relate. They should be separately disclosed by way of note or, where it is necessary in order that the financial statements give a true and fair view, on the face of the profit and loss account.

iii The following items, including provisions in respect of such items, should be shown separately on the face of the profit and loss account after operating profit and before interest:

- profits or losses on the sale or termination of an operation;
- costs of a fundamental reorganisation or restructuring; and
- profits or losses on the disposal of fixed assets.

iv Extraordinary items should be disclosed.

d Earnings per share should be calculated on the profit attributable to equity shareholders of the reporting entity, after accounting for minority interests, extraordinary items, preference dividends and other appropriations in respect of preference shares. Where a reporting entity wishes to present an additional earnings per share calculated on another level of earnings the additional indicator should be presented on a consistent basis over time and, wherever disclosed, reconciled to the amount required by the FRS. Such a reconciliation should list the items for which an adjustment is being made and disclose their individual effect on the calculation. The earnings per share required by the FRS should be at least as prominent as any additional version presented and the reason for calculating the additional version should be explained.

e The note of historical cost profits and losses is a memorandum item, the primary purpose of which is to present the profits or losses of reporting entities that have revalued assets on a more comparable basis with those of entities that have not. It is an abbreviated restatement of the profit and loss account which adjusts the reported profit or loss, if necessary, so as to show it as if no asset revaluations had been made. Unless the historical cost information is unavailable, the note is required whenever there is a material difference between the result as disclosed in the profit and loss account and the result on an unmodified historical cost basis; it should be presented immediately following the profit and loss account or the statement of total recognised gains and losses.

f The statement of total recognised gains and losses is a primary financial statement that enables users to consider all recognised gains and losses of a reporting entity in assessing its overall performance. It, therefore, includes the profit or loss for the period together with all other movements on reserves reflecting recognised gains and losses attributable to shareholders. The statement is not intended to reflect the realisation of gains recognised in previous periods nor does it deal with transfers between reserves, which should continue to be shown in the notes to the financial statements.

g The reconciliation of movements in shareholders' funds brings together the performance of the period, as shown in the statement of total recognised gains and losses, with all the other changes in shareholders' funds in the period, including capital contributed by or repaid to shareholders.

h Prior period adjustments should be accounted for by restating the comparative figures for the preceding period in the primary statements and notes and adjusting the opening balance of reserves for the cumulative effect. The cumulative effect of the adjustments should also be noted at the foot of the statement of total recognised gains and losses of the current period. The effect of prior period adjustments on the results for the preceding period should be disclosed where practicable.

i The accounting practices set out in the FRS should be adopted as soon as possible and regarded as standard in respect of financial statements relating to accounting periods ending on or after 22 June 1993.

## OBJECTIVE

1 The objective of the FRS is to require reporting entities falling within its scope to highlight a range of important components of financial performance to aid users in understanding the performance achieved by a reporting entity in a period and to assist them in forming a basis for their assessment of future results and cash flows.

## DEFINITIONS

***The following definitions apply for the purposes of the FRS and in particular the statement of standard accounting practice set out in paragraphs 12 to 33.***

**2** *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.

**3** *Acquisitions :-*
Operations of the reporting entity that are acquired in the period.

**4** *Discontinued operations :-*
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.

5 *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.

6 *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.

7 *Prior period adjustments :-*
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.

8 *Total recognised gains and losses :-*
The total of all gains and losses of the reporting entity that are recognised in a period and are attributable to shareholders.

9 *Companies Act 1985 :-*
The Companies Act 1985 as amended by the Companies Act 1989.

10 *Companies (Northern Ireland) Order 1986 :-*
The Companies (Northern Ireland) Order 1986 as amended by the Companies (Northern Ireland) Order 1990 and the Companies (No. 2) (Northern Ireland) Order 1990.

11 *Companies (Amendment) Act 1986 :-*
The Republic of Ireland Companies (Amendment) Act 1986 as amended by the Companies Act 1990 and by the European Communities (Companies: Group Accounts) Regulations 1992 (*the 1992 Regulations*).

## STATEMENT OF STANDARD ACCOUNTING PRACTICE

*The statement of standard accounting practice set out in paragraphs 12 to 33 of the FRS should be read in the context of the Objective of the FRS as stated in paragraph 1, the definitions set out in paragraphs 2 to 11 and also of the Foreword to Accounting Standards and the Statement of Principles for Financial Reporting currently in issue.*

*The Explanation section of the FRS, set out in paragraphs 35 to 66, shall be regarded as part of the statement of standard accounting practice insofar as it assists in interpreting that statement.*

### *Scope*

12 The FRS applies to all financial statements intended to give a true and fair view of a reporting entity's financial position and profit or loss (or income and expenditure). Every such reporting entity should apply the requirements of the FRS except to the extent that these requirements are not permitted by the statutory framework (if any) under which the entity reports.

### *Profit and loss account*

13 All gains and losses recognised in the financial statements for the period should be included in the profit and loss account or the statement of total recognised gains and losses. Gains and losses may be excluded from the profit and loss account only if they are specifically permitted or required to be taken directly to reserves by this or other accounting standards or, in the absence of a relevant accounting standard, by law.

*Continuing and discontinued operations*

14 The aggregate results of each of continuing operations, acquisitions (as a component of continuing operations) and discontinued operations should be disclosed separately. The results of acquisitions included in continuing operations should not include those that are also discontinued in the same period. The minimum disclosure required

down to the operating profit level on the face of the profit and loss account in respect of continuing operations, acquisitions and discontinued operations is the analysis of turnover and operating profit (which for non-financial reporting entities is normally profit before income from shares in group undertakings). The analysis between continuing operations, acquisitions (as a component of continuing operations) and discontinued operations of each of the other statutory profit and loss account format items between turnover and operating profit should be given by way of note where not shown on the face of the profit and loss account. In those circumstances where a reporting entity presents allocations of interest or tax between continuing and discontinued operations, the method and underlying assumptions used in making the allocations should be disclosed.

**15** Where an acquisition, or a sale or a termination, has a material impact on a major business segment this should be disclosed and explained.

*Acquisitions*

**16** Where it is not practicable to determine the post-acquisition results of an operation to the end of the current period, an indication should be given of the contribution of the acquisition to the turnover and operating profit of the continuing operations in addition to the information required by the Companies Act 1985*. If an indication of the contribution of an acquisition to the results of the period cannot be given, this fact and the reason should be explained.

*Discontinued operations*

**17** Only income and costs directly related to discontinued operations should appear under the heading of discontinued operations. Reorganisation or restructuring of continuing operations resulting

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* *Companies Act 1985 Schedule 4A paragraph 13.*

*The equivalent reference in Northern Ireland legislation is the Companies (Northern Ireland) Order 1986 Schedule 4A paragraph 13.*

*The nearest equivalent reference in the Republic of Ireland is the 1992 Regulations section 27 which sets out a general requirement for disclosure in the case of changes in the composition of a group.*

from a sale or termination should be treated as a part of continuing operations.

*The consequences of a decision to sell or terminate an operation*

18 If a decision has been made to sell or terminate an operation, any consequential provisions should reflect the extent to which obligations have been incurred that are not expected to be covered by the future profits of the operation or the disposal of its assets. This principle requires that the reporting entity should be demonstrably committed to the sale or termination. This should be evidenced, in the former case, by a binding sale agreement and, in the latter, by a detailed formal plan for termination from which the reporting entity cannot realistically withdraw. The provision should cover only a) the direct costs of the sale or termination and b) any operating losses of the operation up to the date of sale or termination, in both cases, after taking into account the aggregate profit, if any, to be recognised in the profit and loss account from the future profits of the operation or disposal of its assets. Unless the operation qualifies as a discontinued operation in the period under review, the write down of assets and any provisions should appear in the continuing operations category. In the subsequent period when the operation does qualify as discontinued, the provisions should be used to offset the results of the operation in the discontinued category. The related disclosure in that subsequent period, however, should be to show the results of the discontinued operation under each of the statutory format headings with the utilisation of the provision analysed as necessary between the operating loss and the loss on sale or termination of the discontinued operation and disclosed on the face of the profit and loss account immediately below the relevant items.

*Exceptional items*

19 All exceptional items, other than those included in the items listed in paragraph 20, should be credited or charged in arriving at the profit or loss on ordinary activities by inclusion under the statutory format headings to which they relate. They should be attributed to continuing or discontinued operations as appropriate. The amount of each exceptional item, either individually or as an aggregate of items of a

similar type, should be disclosed separately by way of note, or on the face of the profit and loss account if that degree of prominence is necessary in order to give a true and fair view. An adequate description of each exceptional item should be given to enable its nature to be understood.

**20** The following items, including provisions in respect of such items, should be shown separately on the face of the profit and loss account after operating profit and before interest, and included under the appropriate heading of continuing or discontinued operations:

**a** profits or losses on the sale or termination of an operation;

**b** costs of a fundamental reorganisation or restructuring having a material effect on the nature and focus of the reporting entity's operations; and

**c** profits or losses on the disposal of fixed assets.

In calculating the profit or loss in respect of the above items consideration should only be given to revenue and costs directly related to the items in question.

When the net amount of (a) or (c) above is not material, but the gross profits or losses are material, the relevant heading should still appear on the face of the profit and loss account with a reference to a related note analysing the profits and losses. Relevant information regarding the effect of these items on the taxation charge and, in the case of consolidated financial statements, any minority interests should both be shown in a note to the profit and loss account. As a minimum the related tax and the minority interest should both be shown in aggregate, but if the effect of the tax and minority interests differs for the various categories of items further information should be given, where practicable, to assist users in assessing the impact of the different items on the net profit or loss attributable to shareholders. The taxation effects of these items are also referred to in paragraphs 23 and 24.

*Profit or loss on the disposal of an asset*

21 The profit or loss on the disposal of an asset should be accounted for in the profit and loss account of the period in which the disposal occurs as the difference between the net sale proceeds and the net carrying amount, whether carried at historical cost (less any provisions made) or at a valuation.

*Extraordinary items*

22 Any extraordinary profit or loss should be shown separately on the face of the profit and loss account, after the profit or loss on ordinary activities after taxation but before deducting any appropriations such as dividends paid or payable and, in the case of consolidated financial statements, after the figure for minority interests. The amount of each extraordinary item should be shown individually either on the face of the profit and loss account or in a note and an adequate description of each extraordinary item should be given to enable its nature to be understood. The tax on extraordinary profit or loss and, in the case of consolidated financial statements, the extraordinary profit or 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. Any subsequent adjustments to the tax on extraordinary profit or loss in future periods should be shown as an extraordinary item.

*Taxation*

23 Any special circumstances that affect the overall tax charge or credit for the period, or that may affect those of future periods, should be disclosed by way of note to the profit and loss account and their individual effects quantified. Such disclosures should include any special circumstances affecting the tax attributable to the items specified in paragraph 20. 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.

24 The tax on items of the type listed in paragraph 20 or on an extraordinary profit or loss should be determined by computing the tax on the profit or loss on ordinary activities as if the items did not exist, and comparing this notional tax charge with the tax charge on the profit or loss for the period (after extraordinary items). Any additional tax charge or credit (including deferred tax) arising should be attributed to the items. If there are items in both groups in the same period, the tax on the items combined should be calculated then apportioned between the two groups in relation to their respective amounts, unless a more appropriate basis of apportionment is available. If a more appropriate basis is adopted the method of apportionment should be disclosed.

### *Earnings per share*

25 Paragraph 10 of SSAP 3 concerning the definition of earnings per share is withdrawn and replaced by the following paragraph:

> '10 The profit in pence attributable to each equity share, based on the profit (or in the case of a group the consolidated profit) of the period after tax, minority interests and extraordinary items and after deducting preference dividends and other appropriations in respect of preference shares, divided by the number of equity shares in issue and ranking for dividend in respect of the period.'

If an additional earnings per share calculated at any other level of profit is presented it should be presented on a consistent basis over time and, wherever disclosed, reconciled to the amount required by the FRS. Such a reconciliation should list the items for which an adjustment is being made and disclose their individual effect on the calculation. The earnings per share required by the FRS should be at least as prominent as any additional version presented and the reason for calculating the additional version should be explained. The reconciliation and explanation should appear adjacent to the earnings per share disclosure, or a reference should be given to where they can be found.

### *Note of historical cost profits and losses*

**26** Where there is a material difference between the result as disclosed in the profit and loss account and the result on an unmodified historical cost basis, a note of the historical cost profit or loss for the period should be presented. 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 of the historical cost profit or loss should include a reconciliation of the reported profit on ordinary activities before taxation to the equivalent historical cost amount and should also show the retained profit for the financial year reported on the historical cost basis. The note should be presented immediately following the profit and loss account or the statement of total recognised gains and losses.

### *Statement of total recognised gains and losses*

**27** A primary statement should be presented, with the same prominence as the other primary statements, showing the total of recognised gains and losses and its components. The components should be the gains and losses that are recognised in the period insofar as they are attributable to shareholders*.

### *Reconciliation of movements in shareholders' funds*

**28** A note should be presented reconciling the opening and closing totals of shareholders' funds of the period.

### *Prior period adjustments*

**29** Prior period adjustments should be accounted for by restating the comparative figures for the preceding period in the primary statements

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* *As explained in UITF Abstract 3 and paragraphs 6 and 7 of SSAP 22 'Accounting for goodwill', the immediate write-off to reserves of purchased goodwill is not a recognised loss.*

and notes and adjusting the opening balance of reserves for the cumulative effect. The cumulative effect of the adjustments should also be noted at the foot of the statement of total recognised gains and losses of the current period. The effect of prior period adjustments on the results for the preceding period should be disclosed where practicable.

### *Comparative figures*

30 Comparative figures should be given for all items in the primary statements and such notes thereto as are required by the FRS. The comparative figures in respect of the profit and loss account should include in the continuing category only the results of those operations included in the current period's continuing operations.

### *Investment companies*

31 Investment companies as defined in companies legislation should include in the profit and loss account only profits available for distribution.

### *Date from which effective*

32 The accounting practices set out in the FRS should be adopted as soon as possible and regarded as standard in respect of financial statements relating to accounting periods ending on or after 22 June 1993.

### *Withdrawal of SSAP 6 and amendment of other statements*

33 The FRS supersedes SSAP 6 and amends SSAP 3 in accordance with paragraph 25 of the FRS. Related changes to SSAP 3 and other accounting standards follow:

a *SSAP 1* :- paragraph 21 - line 4 "SSAP 6" is replaced by "FRS 3 'Reporting Financial Performance' ";

**b** *SSAP 3* :- paragraphs 18 and 19 are deleted;

**c** *SSAP 3* :- Appendix 1 paragraph 2 – the first sentence is replaced by "The amount earned for equity should be the profit (or, in the case of a group, the consolidated profit) of the period after tax, minority interests and extraordinary items and after deducting preference dividends and other appropriations in respect of preference shares." The footnote to this paragraph is deleted;

**d** *SSAP 3* :- Appendix 1 paragraph 12 – line 2 "normally, the consolidated profit of the period after taxation, minority interests and preference dividends but before extraordinary items" is replaced by "the profit (or, in the case of a group, the consolidated profit) of the period after tax, minority interests and extraordinary items and after deducting preference dividends and other appropriations in respect of preference shares";

**e** *SSAP 4* :- paragraph 14 – line 5 "SSAP 6 'Extraordinary items and prior year adjustments' " is replaced by "FRS 3 'Reporting Financial Performance' as an exceptional item";

**f** *SSAP 4* :- paragraph 30 is replaced by "Any adjustments arising as a result of a change in accounting policy to comply with the requirements of this statement should be accounted for as a prior year adjustment in accordance with FRS 3 'Reporting Financial Performance'.";

**g** *SSAP 8* :- paragraph 10 and Appendix 3 paragraph 13 are each replaced by "Irrecoverable ACT should be treated as part of the tax on ordinary activities." The footnote to paragraph 10 is deleted;

**h** *SSAP 12* :- paragraph 18 – line 12 "SSAP 6 'Extraordinary items and prior year adjustments' " is replaced by "FRS 3 'Reporting Financial Performance' as an exceptional item included under the same statutory format heading as the ongoing depreciation charge." The penultimate and pre-penultimate sentences of paragraph 18 are deleted;

**i** *SSAP 15* :- paragraph 36 – the last sentence is deleted;

j *SSAP 19* :- paragraph 13 – line 6 "investment trust companies (as mentioned in paragraph 10 of SSAP 6)" is replaced by "Companies Act investment companies (as mentioned in paragraph 66 of FRS 3 'Reporting Financial Performance')";

k *SSAP 24* :- paragraph 26 – the last two sentences are replaced by "Where a reduction in the number of employees is related to an event such as the sale or termination of an operation, it is accepted that it may not be possible to apply the rule set out in this paragraph. This is because FRS 3 'Reporting Financial Performance' requires provisions consequent on the sale or termination of an operation to be made after taking account of future profits of the operation or the disposal of its assets. It may therefore not be appropriate to defer recognition of an associated pension cost or credit.";

l *SSAP 24* :- paragraph 53 – line 3 "SSAP 6 (Revised) 'Extraordinary items and prior year adjustments' " is replaced by "FRS 3 'Reporting Financial Performance' ";

m *SSAP 24* :- paragraph 81 – the second sentence is replaced by "Where the significant reduction in the number of employees is related to the sale or termination of an operation, the associated pension cost or credit should be recognised immediately to the extent necessary to comply with the requirements of paragraph 18 of FRS 3 'Reporting Financial Performance'. In all other cases where there is a reduction in contributions arising from a significant reduction in employees the reduction of contributions should be recognised as it occurs.";

n *SSAP 24* :- paragraph 92 – line 3 "SSAP 6 (Revised) 'Extraordinary items and prior year adjustments' " is replaced by "FRS 3 'Reporting Financial Performance' ";

o *SSAP 24* :- paragraph 94 – line 8 "SSAP 6 (Revised)" is replaced by "FRS 3 'Reporting Financial Performance' ";

p *UITF Abstract 1* :- paragraph 6 – line 2 "SSAP 6" is replaced by "FRS 3". In the references section "Statement of Standard Accounting Practice 6 – Extraordinary items and prior year adjustments" is replaced by "FRS 3 'Reporting Financial Performance' ";

**q** *UITF Abstract 2* :- is withdrawn;

**r** *UITF Abstract 5* :- references section "Statement of Standard Accounting Practice 6 - Extraordinary items and prior year adjustments - paragraph 33" is replaced by "FRS 3 'Reporting Financial Performance' - paragraph 13".

***Financial Reporting Standard No. 3 'Reporting Financial Performance' was adopted by a vote of eight of the nine members of the Accounting Standards Board. Mr Bradfield dissented. His dissenting view is set out on pages 48 to 50.***

*Members of the Accounting Standards Board*

| | |
|---|---|
| David Tweedie | (Chairman) |
| Allan Cook | (Technical Director) |
| Robert Bradfield | |
| Sir Bryan Carsberg | |
| Elwyn Eilledge | |
| Michael Garner | |
| Donald Main | |
| Roger Munson | |
| Graham Stacy | |

## COMPLIANCE WITH INTERNATIONAL ACCOUNTING STANDARDS

34 The requirements of the FRS are consistent with International Accounting Standard 5 'Information to be Disclosed in Financial Statements' and International Accounting Standard 8 'Unusual and Prior Period Items and Changes in Accounting Policies'. The FRS is also consistent with the exposure draft of a proposed revised International Accounting Standard - 'Extraordinary Items, Fundamental Errors and Changes in Accounting Policies' issued by the International Accounting Standards Committee in July 1992.

## EXPLANATION

### *Components of financial performance*

35 The many parts of a reporting entity's activities exhibit features which differ in stability, risk and predictability, indicating a need for the separate disclosure of components of financial performance in the profit and loss account and in the statement of total recognised gains and losses. The disclosure of these components is designed to facilitate understanding of the performance achieved in a period and to assist users in deciding on the extent to which past results are useful in helping to assess potential future results. A component, of whatever nature, should be shown separately if it has a special significance for the assessment of some aspect of performance.

36 The total of all recognised gains and losses attributable to shareholders of a reporting entity includes the following components:

a profit or loss before the deduction of dividends;

b adjustments to the valuation of assets; and

c differences in the net investment in foreign enterprises arising from changes in foreign currency exchange rates.

37 The profit and loss account and statement of total recognised gains and losses are intended to present all the entity's gains and losses recognised in a particular period. Profit or loss of a period focuses on what a reporting entity earns for its output (revenue) and what it sacrifices to obtain that output (expenses). Gains and losses may be excluded from the profit and loss account only if they are specifically permitted or required to be taken directly to reserves by this or other accounting standards or, in the absence of a relevant accounting standard, by law. For example, a gain on the revaluation of a fixed asset should be reflected directly in the statement of total recognised gains and losses of the period in which the revaluation takes place. The realisation, or part realisation, of such a gain on the sale of the asset in a subsequent period is not itself a gain of that later period but, rather, confirmation of a gain

that had already occurred by the time of the revaluation. Consequently, the gain or loss on the disposal of the asset is to be calculated as the difference between the net sale proceeds and the net carrying amount.

### *Profit and loss account*

*Continuing and discontinued operations*

38 The objective of reporting separately the results of continuing operations, acquisitions (as a component of continuing operations) and discontinued operations is to assist users, first, in assessing the financial performance of these aspects of a reporting entity's operations and, secondly, in forming a basis for the assessment of future income. Separate presentation assists analysis of the significance of the part of a reporting entity's operations that has ceased and of new operations that have been acquired. The various aspects of the definition and requirements regarding discontinued operations are explained in paragraphs 41 to 44. In respect of acquisitions, the requirement is to disclose their post-acquisition results for the period in which the acquisition occurs. In some circumstances it may also be useful to users for the results of acquisitions for the first full financial year for which they are a part of the reporting entity to be disclosed in the notes.

39 The FRS requires each of the statutory profit and loss account headings between turnover and operating profit to be analysed between continuing operations, acquisitions (as a component of continuing operations) and discontinued operations. For non-financial reporting entities operating profit is normally profit before income from shares in group undertakings, although in certain cases income from associated undertakings or from other participating interests may be considered to be part of operating profit. In order to avoid too much data on the face of the profit and loss account, the minimum disclosure required there in respect of continuing operations, acquisitions and discontinued operations is the analysis of turnover and operating profit. A similar analysis is required between continuing and discontinued operations for the items specifically required to be disclosed by paragraph 20;

where practicable this analysis should identify, either on the face of the profit and loss account or in the notes, the amounts arising in respect of acquisitions.

40 The analysis in respect of continuing operations, acquisitions and discontinued operations is required only to the profit before interest level because interest payable is often a reflection of a reporting entity's overall financing policy, involving both equity and debt funding considerations on a group wide basis, rather than an aggregation of the particular types of finance allocated to individual segments of the reporting entity's operations. Any allocation of interest would involve a considerable degree of subjectivity, that could leave the user uncertain as to the relevance and reliability of the information. If a reporting entity wishes to provide such an allocation, the FRS requires that the method and underlying assumptions used in making the allocation be disclosed.

*Discontinued operations*

41 The FRS requires operations to be classified as discontinued when 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. Only the results of operations up to the balance sheet date should be included; operations in the subsequent period should be included in the results of that period, separately classified as discontinued if material. Any income and costs associated with a sale or termination that has not been completed are to be included in the continuing category. In some cases it may be appropriate to disclose separately in a note to the profit and loss account the results of operations which although not discontinued are in the process of discontinuing, but they should not be classified as discontinued.

42 To be included in the category of discontinued operations, a sale or termination must have a material effect on the nature and focus of the reporting entity's operations and 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 its continuing markets. The nature and focus of a reporting entity's operations refers to the positioning of its products or services in their markets including the aspects of both quality and location. For example, if a hotel company which had traditionally served the lower end of the hotel market sold its existing chain and bought luxury hotels then, while remaining in the business of managing hotels, the group would be changing the nature and focus of its operations. A similar situation would arise if the same company were to sell its hotels in, say, the United States of America and buy hotels in Europe. The regular sales and replacements of material assets which are undertaken by a reporting entity as part of the routine maintenance of its portfolio of assets should not be classified as discontinuances and acquisitions. In the example, the sale of hotels and the purchase of others within the same market sector and similar locations would be treated as wholly within continuing operations.

**43** To be classified as discontinued a sale or termination should have resulted from a strategic decision by the reporting entity either to withdraw from a particular market (whether class of business or geographical) or to curtail materially its presence in a continuing market (i.e. 'downsizing'). The sale or termination of a component of a reporting entity's operations which is undertaken primarily in order to achieve productivity improvements or other cost savings is a part of that entity's continuing operations and the effects of the sale or termination should be included under that heading.

**44** To be classified as discontinued, the assets, liabilities, results of operations and activities of an operation must be clearly distinguishable, physically, operationally and for financial reporting purposes. If the financial results of a sold or terminated operation are not identifiable separately from the accounting records or to a material extent can only be derived through making allocations of income or expenses, then the operation cannot be classified as a discontinued operation. For example, a manufacturing facility that is closed down but which lacks an external market price for its output cannot be classified as a discontinued operation.

*The consequences of a decision to sell or terminate an operation*

**45** Paragraph 18 sets out the principle underlying the establishment of provisions as a consequence of a decision to sell or terminate an operation. This principle focuses on the fact that an obligation arises at the point when the reporting entity becomes demonstrably committed to the sale or termination. Evidence of the commitment might be the public announcement of specific plans, the commencement of implementation, or other circumstances effectively obliging the reporting entity to complete the sale or termination. A binding contract entered into after the balance sheet date may provide additional evidence of asset values and commitments at the balance sheet date. In the case of an intended sale for which no legally binding sale agreement exists, no obligation has been entered into by the reporting entity; accordingly, provisions for the direct costs of the decision to sell and for future operating losses should not be made. In accordance with normal practice, however, any permanent diminutions in asset values should be recorded.

*Exceptional items*

**46** Exceptional items are defined in paragraph 5. They are an inherent part of the normal activities of a reporting entity and are included in the computation of profit or loss on ordinary activities but, because of their exceptional size or incidence, require separate disclosure to explain the performance of a period. Exceptional items may arise from a variety of sources and for larger or more complex businesses they are likely to occur in one form or another in most periods. They should not be aggregated on the face of the profit and loss account under one heading of exceptional items but, rather, each should be included within its natural statutory format heading or paragraph 20 category and separately disclosed in accordance with the requirements of paragraphs 19 and 20. The nature of exceptional items makes it necessary to distinguish exceptional profits from exceptional losses, in the notes if not on the face of the profit and loss account. The profits or losses on the disposal of fixed assets in paragraph 20 (c) are not intended to include profits and losses that are in effect no more than marginal adjustments to depreciation previously charged. In any references to profit or loss as including or excluding exceptional items, an explanation should be given of the relevance of their inclusion or exclusion (as the case may be) in the context of considering the results of the period or assessing maintainable earnings.

**47** Exceptional items may occur in either continuing or discontinued operations and need to be identified individually as belonging to one or other category. In showing the amount of each exceptional item, individual items or groups of a similar type of item should not be combined if separately they relate to continuing and to discontinued operations.

*Extraordinary items*

**48** Extraordinary items are defined in paragraph 6. Extraordinary items should be shown on the face of the profit and loss account before deducting any appropriations such as dividends paid or payable and, in the case of consolidated financial statements, after the figure for minority interests. Extraordinary items are extremely rare as they relate to highly abnormal events or transactions that fall outside the ordinary activities of a reporting entity and which are not expected to recur. In view of the extreme rarity of such items no examples are provided. Items falling into the category of exceptional in accordance with the terms of the FRS cannot, by definition, be extraordinary.

**49** The FRS follows companies legislation in requiring the tax on extraordinary profit or loss and, in the case of consolidated financial statements, the minority shareholders' interest in an extraordinary profit or loss, to be shown separately.

*Taxation*

**50** Companies legislation requires disclosure in the notes of the details of any special circumstances that affect any liability to taxation, whether for the financial year in question or for future years, and whether in respect of profits, income or capital gains. Such special circumstances could include, for example, the effect on the tax charge of losses whether utilised or carried forward. This disclosure can be useful in understanding the period's charge or credit in respect of taxation, particularly when there are items of the type specified in paragraph 20. It is recognised that analysing an entity's total taxation charge between component parts of its result for a period can involve arbitrary allocations that tend to become less meaningful the more components there are. However, in respect of items such as disposal profits or losses the tax can often be identified with the exceptional item concerned and the relationship between the profit or loss and the attributable tax may be significantly different from that in respect of operating profits or losses. In such circumstances it is relevant to identify the tax charge or credit more specifically. Disclosure of special circumstances can also be useful in assessing likely future amounts of taxation. Therefore, the FRS requires that the notes should not only disclose the existence of any special circumstances but should also quantify their individual effects.

51 The application of the fundamental accounting concept of consistency requires that the tax effects of an extraordinary item should themselves be treated as extraordinary. This principle would apply even where an extraordinary item and its tax effects are recognised in different periods, such as where the tax relief in respect of an extraordinary loss is not recognised until it is utilised in a subsequent period.

### *Earnings per share*

52 It is not possible to distil the performance of a complex organisation into a single measure. Undue significance, therefore, should not be placed on any one such measure which may purport to achieve this aim. To assess the performance of a reporting entity during a period all components of its activities must be considered. For this reason and to provide a starting point for analysis, the FRS requires earnings per share to be calculated on profit attributable to equity shareholders of the reporting entity. If preparers wish to highlight any other version of earnings per share, they are required to provide an explanation of the particular significance they are attaching to that version and to itemise and quantify the adjustments they are making to the earnings per share required by the FRS.

### *Segmental reporting*

53 It is important for a thorough understanding of the results and financial position of a reporting entity that the impact of changes on material components of the business should be highlighted. To assist in this objective, if an acquisition, a sale or a termination has a material impact on a major business segment the FRS requires that this impact should be disclosed and explained.

### *Note of historical cost profits and losses*

54 The note of historical cost profits and losses is a memorandum item that is an abbreviated restatement of the profit and loss account adjusting the reported profit or loss, if necessary, so as to show it as if no asset revaluations had been made. Adjustments are made for such items as:

- **a** gains recognised in prior periods in the statement of total recognised gains and losses and realised in the current period; for example, the difference between the profit on the disposal of an asset calculated on depreciated historical cost and that calculated on a revalued amount; and

- **b** the difference between an historical cost depreciation charge and the depreciation charge calculated on the revalued amount included in the profit and loss account of the period.

55 Two reasons for disclosing the profit or loss for a period on the unmodified historical cost basis of accounting are commonly cited. The first is, that for as long as discretion exists on the timing or scale of revaluations included in financial statements, the unmodified historical cost basis will give the reported profits or losses of different reporting entities on a more comparable basis. The second is the wish of certain users to assess the profit or loss on sale of assets based on their historical cost, rather than, as the FRS requires, on their revalued carrying amount. In acknowledgement of these concerns, the Board has made the provision of a note of historical cost profits and losses a

requirement of the FRS in those circumstances where there is a material difference between the result as disclosed in the profit and loss account and the result on an unmodified historical cost basis. 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 of historical cost profits and losses should be presented immediately following the profit and loss account or the statement of total recognised gains and losses. In consolidated financial statements, the profit and loss account figure for minority interests should be amended for the purposes of this note to reflect the adjustments made where they affect subsidiary companies with a minority interest. For the purpose of paragraph 26 the following are not deemed to be departures from the historical cost convention: (a) adjustments necessarily made to cope with the impact of hyper-inflation on foreign operations and (b) the practice of market makers and other dealers in investments of marking to market where this is an established industry practice.

### *Statement of total recognised gains and losses*

56 The range of important components of financial performance which the FRS requires reporting entities to highlight would often be incomplete if it stopped short at the profit and loss account, since certain gains and losses are specifically permitted or required by law or an accounting standard to be taken directly to reserves. An example is an unrealised gain, such as a revaluation surplus on fixed assets. It is necessary to consider all gains and losses recognised in a period when assessing the financial performance of a reporting entity during that period. Accordingly, the FRS requires, as a primary statement, a statement of total recognised gains and losses to show the extent to which shareholders' funds have increased or decreased from all the various gains and losses recognised in the period. It follows from this perspective that the same gains and losses should not be recognised twice (for example, a holding gain recognised when a fixed asset is revalued should not be recognised a second time when the revalued asset is sold).

57 Statements of total recognised gains and losses contribute further to the purposes of financial reporting by:

a combining information about operating and related performance with other aspects of a reporting entity's financial performance; and

b providing information (jointly with the other primary statements) that is useful for assessing the return on investment in a reporting entity.

If a reporting entity has no recognised gains or losses other than the profit or loss for the period a statement to this effect immediately below the profit and loss account will satisfy the requirement of paragraph 27.

58 Where there is a material recognised movement between the amount attributable to different classes of shareholders which does not affect total shareholders' funds an explanatory footnote to the statement may be appropriate. An example might be an appropriation of profit to accrue a premium on redemption of preference shares.

### *Reconciliation of movements in shareholders' funds*

59 The profit and loss account and the statement of total recognised gains and losses reflect the performance of a reporting entity in a period. There are, however, other changes in shareholders' funds that can also be important in understanding the change in the financial position of the entity. The purpose of the reconciliation of movements in shareholders' funds is to highlight those other changes. If included as a primary statement, the reconciliation should be shown separately from the statement of total recognised gains and losses.

### *Prior period adjustments*

60 The majority of items relating to prior periods arise mainly from the corrections and adjustments which are the natural result of estimates inherent in accounting and more particularly in the periodic

preparation of financial statements. They are dealt with in the profit and loss account of the period in which they are identified and their effect is stated where material. They are not exceptional or extraordinary merely because they relate to a prior period; their nature will determine their classification. Prior period adjustments, that is prior period items which should be adjusted against the opening balance of retained profits or reserves, are rare and limited to items arising from changes in accounting policies or from the correction of fundamental errors.

**61** Estimating future events and their effects requires the exercise of judgement and will require reappraisal as new events occur, as more experience is acquired or as additional information is obtained. Because a change in estimate arises from new information or developments, it should not be given retrospective effect by a restatement of prior periods. Sometimes a change in estimate may have the appearance of a change of accounting policy and care is necessary to avoid confusing the two.

**62** It is a fundamental accounting concept that there is consistency of accounting treatment within each accounting period and from one period to the next. A change in accounting policy may therefore be made only if it can be justified on the grounds that the new policy is preferable to the one it replaces because it will give a fairer presentation of the result and of the financial position of a reporting entity. It is a characteristic of a change in accounting policy that it is the result of a choice between two or more accounting methods. Therefore it does not arise from the adoption or modification of an accounting method necessitated by transactions or events that are clearly different in substance from those previously occurring. Following a change in accounting policy, the amounts for the current and corresponding periods should be restated on the basis of the new policies. The cumulative adjustments should also be noted at the foot of the statement of total recognised gains and losses of the current period and included in the reconciliation of movements in shareholders' funds of the corresponding period in order to highlight for users the effect of the adjustments.

63 In exceptional circumstances it may be found that financial statements of prior periods have been issued containing errors which are of such significance as to destroy the true and fair view and hence the validity of those financial statements. The corrections of such fundamental errors and the cumulative adjustments applicable to prior periods have no bearing on the results of the current period and they are therefore not included in arriving at the profit or loss for the current period. They are accounted for by restating prior periods, with the result that the opening balance of retained profits will be adjusted accordingly, and highlighted in the reconciliation of movements in shareholders' funds. As the cumulative adjustments are recognised in the current period, they should also be noted at the foot of the statement of total recognised gains and losses of the current period.

### *Comparative figures*

64 Comparative figures should be given for all items in the primary statements and such notes thereto as are required by the FRS. To aid comparison, the comparative figures in respect of the profit and loss account should be based on the status of an operation in the financial statements of the period under review and should, therefore, include in the continuing category only the results of those operations included in the current period's continuing operations. The comparative figures appearing under the heading 'continuing operations' may include figures which were shown under the heading of acquisitions in that previous period; no reference need be made to the results of those acquisitions, since they are not required to be presented separately in the current year. Where, however, information on acquisitions is provided voluntarily in respect of the first full year, it may be helpful to provide comparative figures for those acquisitions. Similarly, the comparative figures for discontinued operations will include both amounts relating to operations discontinued in the previous period and amounts relating to operations discontinued in the period under review, which in the previous period would have been included as part of continuing operations. The analysis of comparative figures between continuing and discontinued operations is not required on the face of the profit and loss account.

### *Investment companies*

65 The FRS is based on the view that the profit and loss account for the period should include and show separately all gains and losses which are recognised in that period, except for those which are specifically permitted or required by this or other accounting standards to be taken directly to reserves or, in the absence of a relevant accounting standard, specifically permitted or required by law to be taken directly to reserves. This is a concept which applies to all types of reporting entity, although the precise form of presentation of the results of financial performance will vary between types of reporting entity.

66 Investment companies as defined in section 266 of the Companies Act 1985* (Companies Act investment companies) have special legal provisions regarding the recording of unrealised capital losses, with the result that their profit and loss accounts are not comparable with those of other reporting entities. In the case of such investment companies all recognised gains and losses of a capital nature should be shown only in the statement of total recognised gains and losses leaving the profit and loss account to be confined to profits available for distribution.

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* *The equivalent legislation in Northern Ireland is Article 274 of the Companies (Northern Ireland) Order 1986.*

*The equivalent legislation in the Republic of Ireland is section 47 of the Companies (Amendment) Act 1983.*

# NOTE ON LEGAL REQUIREMENTS

## *Great Britain*

*General*

67 The requirements of Schedules 4 and 4A to the Companies Act 1985* relating to the form and content of company and group financial statements set out formats for the profit and loss account allowing some flexibility in certain circumstances in the manner in which the information is presented. The provisions of the FRS supplement those legal requirements, while remaining within their bounds.

*Disclosure*

68 Companies Act 1985 Schedule 4 paragraph 54

'(1) The basis on which the charge for United Kingdom corporation tax and United Kingdom income tax is computed shall be stated.

(2) Particulars shall be given of any special circumstances which affect liability in respect of taxation of profits, income or capital gains for the financial year or liability in respect of taxation of profits, income or capital gains for succeeding financial years.'

69 Companies Act 1985 Schedule 4A paragraph 13

'(1) The following information with respect to acquisitions taking place in the financial year shall be given in a note to the accounts.'

'(4) The profit or loss of the undertaking or group acquired shall be stated —

(a) for the period from the beginning of the financial year of the undertaking or, as the case may be, of the parent undertaking of the group, up to the date of the acquisition, and

* *The requirements relating to banking and insurance companies and groups are set out in Schedule 9 to the Companies Act 1985.*

(b) for the previous financial year of that undertaking or parent undertaking;

and there shall also be stated the date on which the financial year referred to in paragraph (a) began.'

**70** Companies Act 1985 Schedule 4A paragraphs 15 and 16

'15 Where during the financial year there has been a disposal of an undertaking or group which significantly affects the figures shown in the group accounts, there shall be stated in a note to the accounts —

(a) the name of that undertaking or, as the case may be, of the parent undertaking of that group, and

(b) the extent to which the profit or loss shown in the group accounts is attributable to profit or loss of that undertaking or group.

16 The information required by paragraph 13, or .... 15 above need not be disclosed with respect to an undertaking which —

(a) is established under the law of a country outside the United Kingdom, or

(b) carries on business outside the United Kingdom,

if in the opinion of the directors of the parent company the disclosure would be seriously prejudicial to the business of that undertaking or to the business of the parent company or any of its subsidiary undertakings and the Secretary of State agrees that the information should not be disclosed.'

*Definition*

**71** Companies Act 1985 section 266

'(1) In section 265 "investment company" means a public company which has given notice in the prescribed form (which has not been revoked) to the registrar of companies of its intention to carry on business as an investment company, and has since the date of that notice complied with the requirements specified below.

(2) Those requirements are —

(a) that the business of the company consists of investing its funds mainly in securities, with the aim of spreading investment risk and giving members of the company the benefit of the results of the management of its funds,

(b) that none of the company's holdings in companies (other than those which are for the time being in investment companies) represents more than 15 per cent. by value of the investing company's investments,

(c) that distribution of the company's capital profits is prohibited by its memorandum or articles of association,

(d) that the company has not retained, otherwise than in compliance with this Part, in respect of any accounting reference period more than 15 per cent. of the income it derives from securities.'

### *Northern Ireland*

72 Schedules 4 and 4A of the Companies (Northern Ireland) Order 1986 are similar to Schedules 4 and 4A of the Companies Act 1985 as referred to in paragraph 67.

73 Paragraph 54 of Schedule 4 of the Companies (Northern Ireland) Order 1986 is similar to paragraph 54 of Schedule 4 of the Companies Act 1985 as set out in paragraph 68.

74 Paragraphs 13, 15 and 16 of Schedule 4A of the Companies (Northern Ireland) Order 1986 are similar to paragraphs 13, 15 and 16 of Schedule 4A of the Companies Act 1985 as set out in paragraphs 69 and 70.

75 Article 274 of the Companies (Northern Ireland) Order 1986 is similar to section 266 of the Companies Act 1985 as set out in paragraph 71.

### *Republic of Ireland*

76 The Schedule of the Companies (Amendment) Act 1986 is similar to Schedule 4 of the Companies Act 1985 as referred to paragraph 67.

77 Paragraph 40 of the Schedule of the Companies (Amendment) Act 1986 is similar to paragraph 54 of Schedule 4 of the Companies Act 1985 as set out in paragraph 68.

78 Section 27 of the 1992 Regulations sets out a general requirement for disclosure in the case of changes in the composition of a group. There are no specific equivalents to paragraphs 13(4) 15 and 16 of Schedule 4A of the Companies Act 1985 as set out in paragraphs 69 and 70.

79 Section 47 of the Companies (Amendment) Act 1983 is similar to section 266 of the Companies Act 1985 as set out in paragraph 71.

# ILLUSTRATIVE EXAMPLES

***These illustrative examples are for general guidance and do not form part of the Financial Reporting Standard. The best form of the disclosure will depend on individual circumstances.***

The example on pages 42 to 46 includes two profit and loss accounts along with a statement of total recognised gains and losses, a note of historical cost profits and losses, a reconciliation of movements in shareholders' funds and certain related notes. The following matters should also be noted:

The entity is a group of companies.

The group has made acquisitions and disposals of operations during the year under review.

In this example there is no extraordinary item. However, the positioning of such an item on the face of the profit and loss account is shown although in practice the caption would not appear if no extraordinary items existed.

The profit and loss account examples include the disclosure of earnings per share numbers and a pro forma reconciliation statement for adjusted earnings per share numbers is also shown.

The profit and loss account examples have been prepared using Format 1* as contained in Schedule 4 of the Companies Act 1985. Equivalent information should be shown if any of the other statutory formats are used.

The example on page 47 is one of a Companies Act investment company.

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* *The equivalent legislation in Northern Ireland is Format 1 in Schedule 4 of the Companies (Northern Ireland) Order 1986.*

*The equivalent legislation in the Republic of Ireland is Format 1 in the Schedule to the Companies (Amendment) Act 1983.*

*Profit and loss account example 1*

| | 1993 | 1993 | 1992 as restated |
|---|---|---|---|
| | £ million | £ million | £ million |
| Turnover | | | |
| Continuing operations | 550 | | 500 |
| Acquisitions | 50 | | |
| | 600 | | |
| Discontinued operations | 175 | | 190 |
| | | 775 | 690 |
| Cost of sales | | (620) | (555) |
| Gross profit | | 155 | 135 |
| Net operating expenses | | (104) | (83) |
| Operating profit | | | |
| Continuing operations | 50 | | 40 |
| Acquisitions | 6 | | |
| | 56 | | |
| Discontinued operations | (15) | | 12 |
| Less 1992 provision | 10 | | |
| | | 51 | 52 |
| Profit on sale of properties in continuing operations | | 9 | 6 |
| Provision for loss on operations to be discontinued | | | (30) |
| Loss on disposal of discontinued operations | (17) | | |
| Less 1992 provision | 20 | | |
| | | 3 | |
| Profit on ordinary activities before interest | | 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 |
| **Earnings per share** | | **39p** | **10p** |
| Adjustments | | Xp | Xp |
| [to be itemised and an adequate description to be given] | | | |
| Adjusted earnings per share | | Yp | Yp |

[Reason for calculating the adjusted earnings per share to be given]

*Profit and loss account example 2*

| | Continuing operations 1993 | Acquisitions 1993 | Discontinued operations 1993 | Total 1993 | Total 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 |
| **Earnings per share** | | | | **39p** | **10p** |
| Adjustments | | | | *Xp* | *Xp* |
| [to be itemised and an adequate description to be given] | | | | | |
| Adjusted earnings per share | | | | *Yp* | *Yp* |

[Reason for calculating the adjusted earnings per share to be given]

*Statement of total recognised gains and losses*

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

*Note of historical cost profits and losses*

| | 1993<br>£ million | 1992<br>as restated<br>£ 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 | 5 | 4 |
| Historical cost profit on ordinary activities before taxation | 59 | 27 |
| Historical cost profit for the year retained after taxation, minority interests, extraordinary items and dividends | 35 | 20 |

## *Notes to the financial statements*

*Note required in respect of profit and loss account example 1*

| | 1993 Continuing £ million | 1993 Discontinued £ million | 1993 Total £ million | 1992 (as restated) Continuing £ million | 1992 (as restated) Discontinued £ million | 1992 (as restated) Total £ million |
|---|---|---|---|---|---|---|
| Cost of sales | 455 | 165 | 620 | 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 |
| Less 1992 provision | 0 | (10) | (10) | | | |
| | 89 | 15 | 104 | | | |

The total figures for continuing operations in 1993 include the following amounts relating to acquisitions: cost of sales £40 million and net operating expenses £4 million (namely distribution costs £3 million, administrative expenses £3 million and other operating income £2 million).

*Note required in respect of profit and loss account example 2*

| | 1993 Continuing £ million | 1993 Discontinued £ million | 1993 Total £ million | 1992 (as restated) Continuing £ million | 1992 (as restated) Discontinued £ million | 1992 (as restated) Total £ million |
|---|---|---|---|---|---|---|
| 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).

*Reconciliation of movements in shareholders' funds*

| | 1993 £ million | 1992 as restated £ million |
|---|---|---|
| Profit for the financial year | 29 | 7 |
| Dividends | (8) | (1) |
| | 21 | 6 |
| Other recognised gains and losses relating to the year (net) | (1) | 18 |
| New share capital subscribed | 20 | 1 |
| Goodwill written-off | (25) | |
| Net addition to shareholders' funds | 15 | 25 |
| Opening shareholders' funds (originally £375 million before deducting prior year adjustment of £10 million) | 365 | 340 |
| Closing shareholders' funds | 380 | 365 |

*Reserves*

| | Share premium account £ million | Revaluation reserve £ million | Profit and loss account £ million | Total £ 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 |
| Goodwill written-off | | | (25) | (25) |
| 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 revaluations | | 4 | | 4 |
| At end of year | 57 | 187 | 118 | 362 |

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

## *Companies Act investment company*

*Profit and loss account*

| | 1993 £ million | 1992 £ million |
|---|---|---|
| Revenue | 35 | 30 |
| Expenses | (11) | (10) |
| | 24 | 20 |
| Interest payable | (5) | (7) |
| Profit on ordinary activities before taxation | 19 | 13 |
| Tax on profit on ordinary activities | (4) | (3) |
| Profit on ordinary activities after taxation | 15 | 10 |
| Minority interests | (1) | (1) |
| Profit available for distribution | 14 | 9 |
| Dividends | (13) | (8) |
| Transfer to revenue reserves | 1 | 1 |

*Statement of total recognised gains and losses*

| | 1993 £ million | 1992 £ million |
|---|---|---|
| Capital profit on investments | | |
| Realised gains and losses | 52 | 70 |
| Unrealised gains and losses | 138 | 75 |
| | 190 | 145 |
| Tax | (16) | (22) |
| Minority interest | (1) | (4) |
| | 173 | 119 |
| Unrealised surplus on revaluation of tangible fixed assets | 4 | 2 |
| Capital surplus for the year | 177 | 121 |
| Revenue profit available for distribution | 14 | 9 |
| Total recognised gains and losses for the year | 191 | 130 |
| Distributable profits | | |
| Revenue profit available for distribution | 14 | 9 |
| Dividends | (13) | (8) |
| Transfer to distributable reserves | 1 | 1 |
| Non-distributable profits | | |
| Transfer to non distributable reserves | 177 | 121 |
| | 178 | 122 |

## DISSENTING VIEW

Mr Bradfield dissents from the FRS because he fears that it could frequently produce misleading measures of performance. He notes that it emphasises the components of pre-tax profit, which are now to include the results of business disposals. Shareholders will attach a different level of significance to each of these components - profits from trading being the most important in assessing the underlying performance. However, the FRS ignores, so far as the face of the profit and loss account is concerned, the often material impact in the eyes of shareholders of tax, minority interests and the issue of further shares on each of these components. Here, he believes, the FRS meets neither its own objective nor the intent of many passages in the Board's Statement of Principles.

Under the FRS, the results from trading and business disposals are shown as separate components of profit before tax but are combined thereafter. Information on the tax and minority interests relating to disposals is required, where practicable, to be given in the notes. However, there is no requirement to identify the disposals component of 'profit before tax', 'profit after tax and minorities' or 'earnings per share'. Under SSAP 6, which the FRS replaces, business disposal profits were excluded from all these measures.

Business disposal profits reflect internally generated goodwill often accrued over many years, together with an element of inflation; they are different in kind from the trading results of the year. Pending realisation, they constitute a hidden reserve. They may attract little tax and rarely contain a minority interest. By contrast, Mr Bradfield notes, it is the magnitude and quality of the earnings from trading, after tax and minority interests, that are the focus of attention for the shareholder as he uses the financial statements to assess the continuity of the source of dividends.

Mr Bradfield believes it imperative that users should clearly see the effects of tax and minorities on trading results attributable to shareholders. If, in an international group of companies, the pre-tax trading profits in a low tax regime were to fall and those in a high tax regime were to rise by an identical amount, the shareholder would be materially worse off. SSAP 6 clearly displayed this decline; the FRS serves only to mask it.

Mr Bradfield notes that increasing tax and minority interests can convert an improvement in trading profit, from one year to the next, into a decline in profit attributable to shareholders. Also, where both disposal profits and losses arise, a modest pre-tax result from disposals can be transformed into a substantial after-tax result. Superimposing these elements of profit, as opposed to displaying them separately, may create a reassuring facade which will hide the underlying trend from many users of accounts. If, in addition, there has been a rights issue or an acquisition for shares, users will be left without a single indicator of whether the entity has done well or badly. SSAP 6, when faithfully applied, coped with all these situations.

In Mr Bradfield's view, such outcomes conflict with many of the qualities of financial statements referred to in chapter 2 of the draft Statement of Principles ('The Objective of Financial Statements and Qualitative Characteristics of Financial Information'). These qualities include:

> 'comparability', whereby 'users must be able to compare the financial statements of an enterprise over time to identify trends in its financial ... performance' (paragraph 34); and
>
> 'understandability', whereby information should be 'readily understandable by users' (paragraph 38).

Furthermore, Mr Bradfield believes that the main sub-totals from 'profit before taxation on ordinary activities' downwards impart no useful information to the user. They therefore conflict with the twin primary characteristics of 'relevance' (paragraph 23) and 'reliability' (paragraph 26); in the latter case because of failure to 'represent faithfully the effect of the transactions and other events' (paragraph 28). Mr Bradfield therefore believes that the FRS will fail to meet the reasonable expectations of users of financial statements.

Mr Bradfield has suggested some alternative routes for the FRS. One would require each of the headings 'profit before tax', 'profit after tax and minorities' and 'earnings per share' to be analysed into two parts: one from trading and one from disposals. This remains an option open to preparers. He believes that it would enable individual profit and loss accounts, five year summaries and summary financial statements to present helpful and realistic pictures that accord with users' expectations of financial reporting.

# THE DEVELOPMENT OF THE STANDARD

## *General*

i SSAP 6, which is superseded by FRS 3, was originally issued in 1974 and was based on the 'all-inclusive' concept of profit. It was revised as recently as 1986, but, in spite of a number of improvements that were included, there remained significant problems with its interpretation in practice, particularly in respect of the variety of treatments of apparently similar events as either ordinary or extraordinary items in the profit and loss account. The 1986 revision had not achieved the objective of narrowing the differences and variety of accounting practice in this area and calls for change had been heard from users of financial statements as well as from many preparers and auditors involved with the problem.

ii The Board responded by proposing a major change to the presentation of financial performance both in the profit and loss account itself and for items passing through reserves. Its initial proposals were issued in a discussion draft in April 1991 and these were developed in Financial Reporting Exposure Draft 1 'The Structure of Financial Statements - Reporting of Financial Performance' (FRED 1) published in December 1991.

iii The FRS has retained the essential features of FRED 1, in particular the shift of emphasis from a single performance indicator. The Board believes that the performance of complex organisations cannot be summarised in a single number and has therefore adopted an 'information set' approach that highlights a range of important components of performance. This approach inevitably means that financial statements will sometimes appear more complex than under the former standard. However, it is widely accepted that certain totals in the profit and loss account, such as profit before tax and earnings per share, have been used too simplistically and have obscured the significance of relevant underlying components of financial performance. The presentation and disclosure requirements of the FRS should provide a framework which will facilitate the analysis and interpretation of the various aspects of performance.

iv Under the previous SSAP 6 approach, the inconsistencies underlying earnings per share (calculated before extraordinary items) were not clearly evident to users of financial statements and automatic reliance was often placed on the resultant numbers without there being sufficient awareness of the subjective judgements of the preparers in what was included or excluded. In future earnings per share will be all-inclusive with the result that significant variations from one period to another or the absence of expected variations, whatever the cause, will demand some explanation. Earnings per share will tend to be more volatile than under SSAP 6, because, for example, they will include all business disposal profits and losses, but, as indicated above, there was, in any event, significant inconsistency in how SSAP 6 was applied in practice. Moreover, the FRS permits preparers of financial statements to present additional versions of earnings per share provided that (a) the assumptions on which they are based are explicitly disclosed, (b) the reasons for presenting the additional versions are explained and (c) there is consistency in the approach adopted. It is recognised that users may develop methods to calculate and publish an adjusted earnings per share of individual reporting entities on the basis of an independent assessment of financial statements. The FRS should facilitate such assessments by requiring the provision of a range of relevant information.

v It will be for users to identify particular components that they consider of significance in varying circumstances. This is a feature of the information set approach. For the reasons stated above, it will not be appropriate under FRS 3 (any more than it was in practice under SSAP 6) for users to pay particular attention to any 'headline' number on the face of the profit and loss account or statement of total recognised gains and losses without considering the number's composition. Using the information required by the FRS either on the face of the financial statements or in the notes, users should adapt any headline number to give the performance measure required. The Board considers that the FRS is an important step forward in providing the requisite information to users in a form designed to assist a more mature understanding and analysis of financial performance. Where summarised or highlighted information is presented, (such as a preliminary announcement) it will be the responsibility of the presenters of such information to emphasise the particular components of performance which are of significance in their specific circumstances.

## *Principal changes from FRED 1*

*The consequences of a decision to sell or terminate an operation*

vi FRED 1 did not address the making of provisions in respect of operations that are to be discontinued in future periods. In response to comments received, this issue has been addressed in the FRS.

*Exceptional items*

vii In the light of the proposed severe restrictions on what should be categorised as extraordinary, FRED 1 proposed that a material profit or loss on the sale or termination of an operation should always be shown on the face of the profit and loss account. The FRS has extended this disclosure to two other items - costs of a fundamental reorganisation or restructuring having a material effect on the nature and focus of the reporting entity's operations and profits or losses on the disposal of fixed assets. FRED 1 also proposed that the tax and minority interest attributable to a profit or loss on sale or termination should be shown in a note. In view of the additional items required to be shown on the face of the profit and loss account by the FRS, the Board has given further thought to the question of attributable tax and minority interests and has added paragraphs requiring as a minimum that the aggregate tax and minority interest related to these three items should be disclosed. Preparers should provide further information, where practicable and relevant, identifying the tax and minority interest related to individual categories of these items, in order to assist users in assessing the impact of individual items on the net profit or loss attributable to shareholders.

viii A concern was expressed by respondents to FRED 1 about exceptional items and the prominence they were to be given. In summary, the view was that exceptional items should not be transferred to a single heading of 'exceptional', because profit before exceptional items could then become the focus of financial statement presentations, with the implication that no exceptional items are expected in the future. To meet this concern the FRS requires all exceptional items (other than three specific types of item) to be included in the income or expense heading to which they relate.

*Revenue investment (discretionary expenditure)*

ix The discussion draft introduced the concept of discretionary expenditure. Users of financial statements had encouraged the Board to require disclosure of expenses that are incurred largely for the benefit of future periods and that can therefore be varied by material amounts without affecting current revenues. The draft sought to do this by including a definition along these lines and amplifying it by reference to common examples of such expenses, viz., research and development expense, training, advertising and major maintenance.

x In FRED 1 the concept of discretionary expenditure was developed and in the process the name 'discretionary expenditure' was changed to 'revenue investment'. More detailed guidance was given as to what should be included under this heading and a minimum disclosure requirement was proposed. This was for the disclosure, where material, of the charges to the profit and loss account of the period in respect of research and development, training, advertising and major maintenance and refurbishment. A requirement for an explanation of all material changes between the current and prior period in the level of revenue investment was also proposed.

xi These revenue investment proposals failed to attract support in the context of the proposed accounting standard, and the Board therefore concluded that they should not be pursued by that means. The Board remains of the view that appropriate disclosures of this kind can be of assistance to users of financial statements but in the light of the responses to FRED 1 concluded that the concept can best be developed within the Board's proposals for an Operating and Financial Review to support a company's annual report - i.e. as part of a wider discussion of a company's performance. The Board's decision on the FRED 1 proposal on revenue investment does not in any way affect the existing requirements of SSAP 13 - 'Accounting for research and development' and the Companies Act 1985 regarding the disclosure of research and development activities.

*Reconciliation of movements in shareholders' funds*

**xii** Several respondents to FRED 1, in commenting on the statement of total recognised gains and losses, suggested it should be extended to provide a complete reconciliation of the movements in shareholders' funds. The Board agreed that changes in shareholders' funds other than those included in the statement of total recognised gains and losses can also be important in understanding the change in the financial position of a reporting entity and concluded that this additional information should be required in a reconciliation of movements in shareholders' funds. In order not to divert attention from the components of performance of the total of recognised gains and losses for the period, it specified that if included as a primary statement, the reconciliation should be shown separately from the statement of total recognised gains and losses.

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