

Financial Reporting Update

KPMG LLP (UK)

February 2006

Contents

- [TECH 57/05 Distributable profits](#)
 - Implications of FRS 21 for dividends
- [Business review and OFR](#)
 - Summary of latest guidance
- [Amendments to FRS 23/IAS 21](#)
 - Outline of changes in respect of net investments in a foreign operation
- [Financial instruments: disclosures in 2005 accounts](#)
 - Guidance on disclosure requirements
- [IFRS newsletters](#)
 - Summary

TECH 57/05 Distributable profits

The adoption of FRS 21 *Events after the balance sheet date* (or its equivalent, IAS 10 *Events after the balance sheet date*) will, in many cases, defer the recognition of dividend income received from subsidiaries in the parent's individual accounts. Consequently, parent companies may not have sufficient distributable reserves to support their own dividend policies.

In order to accelerate recognition of dividend income in the parent, the parent may decide that its subsidiaries should pay dividends before the balance sheet date. This matter, as well as the unrelated clarification in respect of the effect on distributable reserves of changes in accounting policy, is addressed in the Institute of Chartered Accountants in England and Wales and the Institute of Chartered Accountants of Scotland (the Institutes) Technical Release, TECH 57/05, issued in December 2005. It applies to financial periods beginning on or after 1 January 2005 and is particularly relevant to companies that have not yet reached their balance sheet date and so may be in a position to take action.

Intra-group dividend income

Under FRS 21, income receivable from proposed dividends is usually recognised later than under previous accounting practice. This is because FRS 21 prohibits dividends declared after the reporting date from being recognised as a liability in the payer's accounts, and hence as income in the recipient company, at that reporting date. Many parent companies may be intending to accelerate recognition of dividend income by arranging for those subsidiaries to pay interim dividends before the parent's year end. However, under standard Table A articles, an interim dividend is paid at the directors' discretion and does not require any form of shareholder approval. FRS 21 defines "declared" as "appropriately authorised and no longer at the discretion of the entity" and hence an interim dividend is not a legally enforceable debt as it is entirely at the directors' discretion. Consequently, dividend income may not be recognised in the parent until the dividend is paid. The question as to when an intra-group interim dividend is paid is addressed by TECH 57/05 and may be summarised as follows:

- When payment is the transfer of cash, the dividend is undoubtedly paid. However, if the cash received is reinvested in the paying company, e.g., by way of an inter-company loan, then consideration should be given as to whether the income is realised in the parent company (see TECH 7/03 A6).
- If the dividend is recorded through an inter-company account that reduces a balance payable from the parent to the subsidiary, the settlement is made by way of set-off rather than by transfer of cash but is equivalent to a payment of cash as at the date the book entries are made by both companies.
- If the dividend is recorded through an inter-company account that creates or increases a liability of the paying subsidiary to the parent, careful consideration is required as to whether this is income in the parent, before assessing whether the income is realised, as follows:
 - If the group has a group treasury function (see TECH 7/03 A4), entries made in the group treasury company's books (debit subsidiary's account and credit parent's account) would normally be regarded as paid.
 - In other circumstances, it is likely that merely recording the accounting entries in the paying and receiving companies will be insufficient. If there were no doubt as to the subsidiary's ability to pay the dividend then the guidance suggests that this matter could be dealt with by effecting a Deed of acknowledgment. However, if the matter is complex and there is uncertainty as to whether the dividend has been paid, the Institutes state that the directors should seek legal advice.

It is possible to remove any doubt as to the parent recognising income by converting the amount into a final dividend before the parent's year end, i.e., a final dividend meets the FRS 21 criteria for recognition (appropriately authorised and no longer at the discretion of the entity). This can be done by the members in a general meeting or, for private companies, by members passing a written resolution.

Changes in accounting policy

TECH 57/05 clarifies when changes in accounting policy should be taken into account in determining profits available for distribution. It makes it clear that the introduction of a new accounting standard is relevant in determining distributable profits only in relation to distributions accounted for in periods in which the change will first be recognised in the accounts. For example, a company's final dividend in respect of 2005 will be paid in 2006. Whilst the starting point for determining the lawfulness of that dividend is the 2005 accounts (as these are the "relevant accounts" under s270 of the Companies Act 1985), the company must consider whether any policy changes to be adopted in 2006 will deplete the profits shown in those 2005 accounts.

The Institutes' technical release is available at

www.icaew.co.uk/index.cfm?AUB=TB21_89176IMNXI_89176

The TECH clarifies the application of this approach to the special case change in policy for dividend recognition itself. Typically a company's 2004 final dividend is shown in the 2004 UK GAAP accounts under SSAP 17 *Post balance sheet events*, and again in the 2005 UK or IFRS accounts under FRS 21 or IAS 10. The TECH clarifies that as the dividend is *first* accounted for in the 2004 accounts, it is the 2004 policies that apply.



Business review and operating and financial review

In December 2005 the Companies Act 1985 (Operating and Financial Review (OFR)) (Repeal) Regulations 2005 were laid before parliament. These regulations are effective from 12 January 2006 and remove the requirement for quoted companies to prepare an OFR. In any event, all companies (except small companies) are still required by virtue of s234ZZB of the Companies Act 1985 to produce an enhanced business review in their directors' reports for periods beginning on or after 1 April 2005. Consequently, parent companies will need to produce a business review at group level and subsidiaries (except those classified as small companies) will also need to produce business reviews in their individual accounts.

These new business review requirements go beyond what was previously required in a Directors' Report and are driven by EU directives. In KPMG in the UK's view, the business review should be included within the Directors' Report itself, reflecting the precise legal requirement for the review. A cross-reference from the Directors' Report to the business review *may* be acceptable if it is to a precise location within the annual report. In particular, the auditors must (for financial periods beginning on or after 1 April 2005) report positively on the consistency of the Directors' Report and accounts, further underlining the need for clear identification of what comprises the Directors' Report.

In summary, the review must:

- be a balanced and comprehensive analysis of the development and performance of the company during the financial year, and the position of the company at the end of the year;
- be consistent with the size and complexity of the business;
- include an analysis using financial key performance indicators, to the extent necessary for an understanding of the development, performance or position of the company;
- where appropriate, include an analysis using other key performance indicators including information relating to environmental and employee matters;
- where appropriate, include references to, and additional explanations of, amounts included in the annual accounts of the company.

The same judgement will need to be used in determining what to include in the business review as would have been the case for the OFR. Directors will need to decide what risks and uncertainties they need to disclose to ensure that a balanced and comprehensive review is given. Companies may not wish to disclose their risks and uncertainties without providing narrative on how they are managed.

The DTI's guidance on the new directors' report is available at www.dti.gov.uk/cld/N00002IU.pdf



Although not explicitly referred to in the legislation, trends and factors affecting the development, performance and position of the business may need to be referred to, where necessary, for a balanced and comprehensive analysis of the business or to describe the principal risks and uncertainties facing the business. Similarly, although the business review legislation contains no specific reference to forward-looking information, many companies may wish to frame their discussions of risks and uncertainties in the context of future prospects.

The Financial Review Reporting Panel will have the legal authority to review Directors' Reports from 1 April 2006 and, if necessary, compel a company to revise its report.

Amendments to FRS 23/IAS 21

The ASB has published two amendments to FRS 23 *The effects of changes in foreign exchange rates* in order to maintain alignment with IAS 21. The amendments are effective for accounting periods beginning on or after 1 January 2006 with earlier adoption encouraged. FRS 23 applies only to those companies that are adopting FRS 26 *Financial instruments: measurement*; other companies that continue to use SSAP 20 *Foreign currency translation* are not affected by the amendments.

FRS 23 has been amended in order to clarify that loans considered to be part of the net investment in a foreign operation (i.e., loans for which settlement is not planned and not likely to occur in the foreseeable future) are **not** limited to those directly between the investor and investee. Loans from other entities within the group may form part of the net investment at group level although an investment in a foreign operation made by an associate of the reporting entity is not part of the reporting entity's net investment in that foreign operation.

A second amendment also broadens the range of currencies in which loans can be denominated and still be considered part of the net investment. Exchange differences arising on the translation of a monetary item that is denominated in **any** currency may now be recognised in equity in the consolidated financial statements when the criteria for qualifying net investments are met.

For those companies adopting EU-endorsed IFRS in their 2005 accounts, the amendment to IAS 21 is unlikely to be endorsed until March/April 2006 or later and hence is unlikely to be part of IFRS endorsed by the EU for financial years ended 31 December 2005. However, the first amendment that clarifies that loans from other group entities may be considered as part of the net investment in a foreign operation is consistent with current interpretations of EU-endorsed IAS 21 and, in KPMG in the UK's view, this approach may therefore be applied

in advance of the adoption of the amendment. The second amendment changes the current requirement of EU-endorsed IAS 21 in respect of the currency in which the net investment may be denominated. Therefore, in our view, this amendment will not be available for adoption by entities preparing financial statements under EU-endorsed IFRS until the amendment has been endorsed.



Financial instruments: disclosures in 2005 accounts

Companies adopting IFRS for the first time in 2005, and indeed UK GAAP preparers adopting the new UK financial instruments standards which are based on the IFRS equivalent, face some complex transitional issues in respect of financial statement disclosure requirements if they are not adopting the financial instruments standards retrospectively. The complexities arise from: the choice of standards available for adoption; the transitional rules in those standards regarding disclosures; and some new Companies Act requirements which, whilst similar are not identical to the disclosure requirements in the accounting standards. In addition, there are new requirements for the directors' report in respect of financial risk management objectives and policies.

Those readers wishing to know more about the issues involved and KPMG in the UK's view on these matters should read the detailed article at the back of this edition.



IFRS newsletters

KPMG IFRG Limited has published the following since the December 2005/January 2006 *Update*, which are available on our Web site at www.kpmg.co.uk:

- *IFRS in Brief*, December 2005 – a summary of the November 2005 meeting of the IASB
- *IFRS Briefing Sheet*, Issue 39 – IASB issues Discussion Paper on Measurement Bases for Financial Accounting – measurement on initial recognition
- *IFRS Briefing Sheet*, Issue 40 – IFRIC Interpretation 7 Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies
- *IFRS Briefing Sheet*, Issue 41 – Amendments to IAS 21 The Effects of Changes in Foreign Exchange Rates – Net investment in a foreign operation.

Stop press

The Financial Reporting Council (FRC) has begun consultation on the possibility on making a small number of changes to the Combined Code. The consultation period ends on 21 April 2006 and, if implemented, the changes would apply to financial years beginning on or after 1 November 2006.

The FRC's consultation document is available on the Web at www.frc.org.uk/corporate/combinedcode.cfm



Financial instruments: disclosures in 2005 accounts

In this article we discuss some of the issues companies may face in respect of financial instruments when preparing financial statements both under IFRS and under UK GAAP during the current reporting cycle (e.g., 31 December 2005 and 31 March 2006 year ends), in particular in respect of comparatives. It also highlights new disclosure requirements incorporated into the Companies Act 1985, some of which apply to *all* entities preparing accounts under UK GAAP, including small companies.

IFRS preparers

IAS 32

At the time of writing, an EU-endorsed IFRS adopter in 2005 will be required to present disclosures in respect of financial instruments in accordance with IAS 32 *Financial instruments: disclosure and presentation*.

As regards comparatives, IFRS 1 *First-time adoption of international financial reporting standards* grants a first-time adopter the option not to prepare comparative information that complies with IAS 32 (and IAS 39 *Financial instruments: recognition and measurement* and IFRS 4 *Insurance contracts*). Where this option is taken an entity is required to apply its "previous GAAP" in the comparative information to financial instruments in the scope of IAS 32, 39 (and insurance contracts in the scope of IFRS 4). In the view of KPMG in the UK, the term "previous GAAP" includes the disclosure requirements of that GAAP. This view is supported by subsequent amendments made to IFRS 1 that are effective if an entity early-adopts IFRS 7 *Financial instruments: disclosures* on first time adoption (see below). Therefore a first-time adopter that uses IAS 32 disclosures in 2005 and takes advantage of the IFRS 1 option to apply "previous GAAP" in the comparative information would, in our view, need to present comparatives for financial instrument disclosures that comply with UK GAAP applicable in 2004 i.e., FRS 4 *Capital instruments*, the Companies Act extant in 2004, FRS 13 *Derivatives and other financial instruments: disclosures* (if relevant), and Statements of Recommended Practice (SORPs). In our view, the new requirements of the Companies Act, (see below) i.e., paragraphs 45A to 45C of Schedule 4 will not apply because they do not form part of "previous GAAP".

In many cases where IAS 32's disclosure requirements are used on first-time adoption of IFRS, the 2004 UK GAAP disclosures will effectively be rolled forward to form the comparatives for 2005. Presentation of these comparatives may require careful consideration because previous UK GAAP and IFRS disclosure requirements are different in several respects. Accordingly, where disclosures are not directly comparable, consideration should be given to using separate notes. Also, where the option to present comparatives on a "previous GAAP" basis is taken, IFRS 1 requires disclosures concerning non-comparability in the financial statements in respect of financial instruments and the accounting policies applied in the comparative period (i.e., previous GAAP).

IFRS 7

Whenever a company adopts IFRS 7 (the latest date is accounting periods beginning on or after 1 January 2007), the disclosure aspects of IAS 32 are superseded.

As regards comparatives, the adoption of IFRS 7 brings with it consequential amendments to IFRS 1 which grant an entity adopting IFRSs for the first time in 2005 the option of not presenting the comparative disclosures required by IFRS 7. Also, whilst a first-time adopter that uses the disclosure aspects of IAS 32 is required by IFRS 1 to apply "previous GAAP" in the comparatives (which, as discussed above, in the view of KPMG in the UK includes disclosure requirements of previous GAAP), a first-time adopter that uses IFRS 7 is required by the amended IFRS 1 to apply "*the recognition and measurement requirements of previous GAAP*" in comparatives. In our view, this amendment has the effect that the revised IFRS 1 as applicable to IFRS 7 adopters is narrower in its requirements regarding "previous GAAP" and as such does not require a first-time adopter to apply disclosure requirements of "previous GAAP" in its comparative information. Therefore, prima facie, a first-time adopter that chooses to use IFRS 7 rather than the disclosure aspects of IAS 32 appears to be able to elect not to present any comparative information for financial instrument disclosures. However, in our view, in the context of a fair presentation it may well be inappropriate to provide no comparative disclosures at all in respect of financial instruments. Accordingly, careful consideration should be given to at least retaining parts of the 2004 UK GAAP financial instruments disclosures to enable the reader to understand the context of the entity's financial position and performance.

Directors' Reports

Companies that prepare their accounts under EU-endorsed IFRS will continue to prepare a Directors' Report in accordance with Schedule 7 to the Companies Act. The requirements of Schedule 7 have been amended in 2005 to include a requirement to make disclosure in respect of financial risk management objectives and policies, including the policy for hedging, and an indication of exposure to financial risk. Comparative disclosure is not required. Where compliant disclosure is included in the notes to the accounts as a result of the application of IAS 32 or IFRS 7, the requirements of Schedule 7 may be met by a cross reference in the Directors' Report to the relevant notes.

UK GAAP preparers*FRS 25 disclosure requirements*

Prior to 2005, entities preparing their accounts under UK GAAP will have provided disclosures in respect of financial instruments by reference to FRS 4, the Companies Act, FRS 13 (if relevant), and SORPs.

For entities with a 31 December 2005 year end the presentation aspects of FRS 25 *Financial instruments: disclosure and presentation* will be relevant and also, potentially, the disclosure requirements of FRS 25 or FRS 29 *Financial instruments: disclosures*. The position is as follows:

- The *presentation* aspects (i.e., debt and equity classification) of FRS 25, that is paragraphs 15 to 50, apply to **all** entities (other than those applying the Financial Reporting Standard for Smaller Entities (FRSSE)) with an accounting period beginning on or after 1 January 2005 (e.g., 31 December 2005 year ends).
- Any entity that adopts FRS 26 *Financial instruments: measurement* **must** adopt either FRS 25 (disclosure aspects), that is paragraphs 51 to 95, or, by early adoption, FRS 29. Companies with capital instruments listed on an EU-regulated market are required to adopt FRS 26 in 2005 (and hence also FRS 25 (disclosure aspects) or FRS 29). Other entities may adopt FRS 26 voluntarily and, if so, these too will be required to adopt FRS 25 (disclosure aspects) or FRS 29.
- Any entity that does not adopt FRS 26 in 2005 may nevertheless volunteer to adopt FRS 25 (disclosure aspects) or FRS 29.
- An entity that does not adopt either FRS 25 (disclosure aspects) or FRS 29 will continue with existing disclosure requirements such as FRS 13. FRS 4 disclosure requirements are withdrawn in 2005 for all companies (however see below in respect of comparatives). For example, AIM companies are outside the scope of FRS 26 and therefore outside the scope of FRS 25's disclosure aspects. FRS 13 will continue to apply to such companies.

Both FRS 25 (disclosure aspects) and FRS 29 contain exemptions for parent companies and certain subsidiary companies that would otherwise be in the scope of those standards. The exemptions are conditional on the entity being included in consolidated accounts that contain disclosures that comply with FRS 25 or FRS 29 (or their IFRS equivalents, i.e., IAS 32 and IFRS 7 respectively). However, entities that take advantage of this exemption must nevertheless comply with the new Companies Act requirements described below. The exemption contained in FRS 25 does not extend to the presentation aspects.

Entities adopting FRSSE are exempt from FRSs 25, 26 and 29.

Comparatives

FRS 25

An entity adopting FRS 25 (disclosure aspects) for the first time in 2005 has the option of not "restating" comparatives to comply with the standard. It is important to note that the option not to "restate" comparatives does not mean that an entity is *exempt* from providing comparatives. Therefore comparative information should be given, albeit on a basis that does not need to comply with FRS 25. It is our view that, in the context of financial instrument disclosures, FRS 25's option not to "restate" comparatives has the effect that comparative disclosures should be provided on the same basis as previously used i.e., FRS 4, Companies Act 1985, FRS 13 (where relevant) and SORPs. The result is an approach that is similar to that available to first-time adopters of IFRSs in 2005 that elect to provide disclosures under IAS 32 rather than early-adopting IFRS 7 as described above.

Additionally, comparative information for the new Companies Act disclosure requirements in respect of financial instruments referred to below (e.g., Schedule 4 paragraphs 45A to 45C) must be provided. This is because there is no specific exemption contained in FRS 28 *Corresponding amounts*. In our view, this applies notwithstanding the fact that comparatives for similar FRS 25 disclosure requirements need not be provided if the option not to restate comparatives is taken. In this regard it is important to note that the disclosure requirements of FRS 25 and the Companies Act are independent of one another. In our view, first-time adopters of IFRSs do not need to provide these new Companies Act disclosures in their comparatives because they do not form part of "previous GAAP".

In terms of the structure of disclosures, it should be noted that the disclosure requirements of FRSs 4 and 13 differ in many ways to those of FRS 25. Therefore, where disclosures are not directly comparable consideration should be given to using separate notes. Like IFRS 1's requirements in respect of IAS 32, FRS 25 also requires disclosures concerning non-comparability in the financial statements in respect of financial instruments and the accounting policies applied in the comparative period, if the option not to restate is taken.

FRS 29

If an entity chooses in 2005 to early-adopt FRS 29 (in which case the disclosure aspects of FRS 25 are not applicable), the approach to comparatives is different. Rather than permitting an entity not to "restate" comparatives, FRS 29 states that an entity need not present comparative information that complies with the standard¹. Therefore, with the exception of disclosures required by the Companies Act, prima facie an entity early-adopting FRS 29 in 2005 appears able to elect not to present any comparative information in respect of financial instrument disclosures. This transitional approach in 2005 for FRS 29 therefore appears similar to the approach taken by IFRS 1 for IFRS 7. However, in our view it may well be inappropriate, in the context of a true and fair view, to provide no comparative information at all for financial instruments disclosures. Accordingly, careful consideration should be given to retaining aspects of 2004 financial instruments disclosure to enable the reader to understand the context of the entity's financial position and performance.

As a separate matter, the disclosure requirements of the Companies Act will continue to apply in the comparatives, including the new requirements described overleaf.

¹ This exemption from the requirement to present comparative information does not extend to the Capital Disclosures requirements set out in Appendix E of FRS 29.

Changes to Companies Act 1985

A key change in 2005 was the introduction of new disclosure requirements into the Companies Act 1985 in respect of financial instruments. For a Schedule 4 company, these disclosures are contained in paragraphs 45A to 45C of Schedule 4 and are summarised as follows:

Schedule 4 Paragraph	Summary of main requirements	Applicable to
45A	Applies when financial instruments have been included in the accounts at fair value under paragraphs 34A or 34C of Schedule 4. Requirements include disclosure of details of any valuation techniques used to arrive at fair value, fair values of each "category" of financial instruments, changes in fair value taken to P&L or reserves, and details, including terms and conditions, of derivatives.	Any entity that uses fair value measurement for financial instruments. Will include but is not exclusive to entities that adopt FRS 26.
45B	Applies where a company has derivatives but has chosen not to include them at fair value. Disclosure of fair value is required together with the "nature and extent" of derivatives.	Any entity that has derivatives (e.g., currency forward contracts) and has not applied FRS 26
45C	Applies where a company has financial instruments that are not included at fair value and carrying amount exceeds fair value. Disclosures include carrying value, fair value, and reason for not making a provision for diminution.	Any entity

Similar disclosure requirements are contained in Schedule 9 for banks, Schedule 9A for insurance companies, and Schedule 8 for small companies.

It is important to note that these Companies Act disclosure requirements differ in some respects from those required by FRS 25 and FRS 29. Therefore entities that comply with those standards cannot assume compliance thereby with the Companies Act. For example:

- Paragraph 45C is based on the pre-2003 version of IAS 32 and was deleted by the IASB as part of the improvements project. Therefore this disclosure requirement does not feature in new IAS 32 (or IFRS 7) and therefore it does not feature in the UK standards that are based on or developed from IAS 32 (or IFRS 7) i.e., FRS 25 (or FRS 29). Therefore Paragraph 45C will always constitute additional disclosure beyond that required by accounting standards.
- Paragraph 45B applies when a company does not fair value derivatives. It therefore follows that such a company will not be applying FRS 26 and therefore will not be in the mandatory scope of FRS 25 (disclosure aspects) or FRS 29. Therefore, paragraph 45B will generally apply when FRS 25 (disclosure aspects) and FRS 29 are *not* being applied.
- Some requirements of paragraph 45A might appear similar to those of FRS 25 and FRS 29. However, in the view of KPMG in the UK, even where they appear similar it is not clear that full compliance with the standards will always achieve compliance with the Act. For example, we note that 45A(2)(b) requires fair value disclosures by “category” of financial instruments (which might, based on FRS 26’s use of that term, be interpreted as meaning available for sale, held to maturity, etc) whereas FRS 25 requires fair value disclosures by “class” of assets (e.g., equities, debt securities, etc).

We note that the Accounting Standards Board (ASB) has included a warning in the standard that FRS 29’s disclosure requirements and those of the Companies Act are generally similar but not identical and therefore that entities within the scope of both will need to ensure that they comply with the requirements of both. A correlation table is provided by the ASB at paragraph N14 of FRS 29.

Directors' Report

Disclosures must be made in the Directors' Report in respect of financial risk management objectives and policies, including the policy for hedging, and an indication of exposure to financial risk. Comparative disclosure is not required. Where disclosures that comply with the revised requirements of Schedule 7 are made in the notes to the accounts as a result of an accounting standard (e.g., based on FRS 13, FRS 25, or FRS 29), this requirement may be satisfied by a cross-reference from the Directors' Report to the relevant note.

If you would like further information on any of the matters discussed in this *Update*, please talk to your usual contact at KPMG LLP (UK) or call any of our offices. Earlier *Updates* are available on our Web site, at www.kpmg.co.uk



The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

The electronic version of KPMG's Financial Reporting Update contains hyperlinks to web sites which are independent of KPMG LLP (UK) and over which KPMG LLP (UK) has no control. To the fullest extent permitted by English law, KPMG LLP (UK) will not accept any responsibility or liability for the content of any such other Web sites or for any consequences.

© 2006 KPMG LLP, the UK member firm of KPMG International, a Swiss cooperative. All rights reserved. Printed in the United Kingdom.

KPMG and the KPMG logo are registered trademarks of KPMG International, a Swiss cooperative.

Designed by Natural

Publication name: Financial Reporting Update

Publication number: 216-307

Publication date: February 2006