

Financial Reporting Update

KPMG LLP (UK)

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Tech 2/07 Distributable profits

In August 2007, the ICAEW and ICAS issued *TECH 2/07 Distributable profit: Implications of recent accounting changes*, which provides extensive guidance on the effect of EU-adopted IFRSs (adopted IFRSs) and more recent UK standards on distributable profits.

TECH 2/07 illustrates how the existing principles of TECH 7/03 (the Institutes' 2003 guidance on realised and distributable profits) apply when profits are measured under adopted IFRSs and also makes some consequential amendments to TECH 7/03. The guidance is comprehensive and includes example journal entries for some of the more complex issues under IAS 32. The main points, drawn from the guidance, are discussed below.

Fair value accounting

Under TECH 7/03, fair value gains on marked to market financial instruments were treated as realised only in limited circumstances. However, the introduction of adopted IFRSs has resulted in many more assets and liabilities being measured at fair value – in particular, financial instruments. TECH 2/07 addresses this issue by providing that fair value gains, e.g. under IAS 39 (FRS 26) *Financial Instruments: Recognition and Measurement*, are realised to the extent that they are “readily convertible to cash”, regardless of whether those gains are reported in the income statement/profit and loss account or taken directly to equity.

“Readily convertible to cash” means, broadly speaking, that an asset can be immediately cashed-in, or, with standard derivatives practices in mind, immediately closed out. For this three conditions must be met:

- a value can be determined at which a transaction could occur without negotiation or marketing;
- observable market data are available to determine the value; and
- the company can actually dispose of or close out the position without curtailing its business or accepting adverse terms.

TECH 2/07 offers further guidance on applying the definition “readily convertible to cash”. One important area is block discounts. Although IAS 39 ignores block discounts in determining the fair value of a financial instrument, block discounts

should be taken into account when calculating how much of a gain is realised – e.g., the IAS 39 fair value of a large holding is 100 but, owing to the effect of block discounts, only 80 is realisable in a short period of time in the ordinary course of business on an active market.

Further guidance is given on investment properties and unquoted investments. Investment property revaluations, which under adopted IFRSs are recognised in the income statement, are unrealised in almost all circumstances because the period for marketing/negotiation disqualifies such properties from being readily convertible to cash. Similar considerations also apply to unquoted equity investments.

Although TECH 2/07 permits fair value gains to be treated as realised in many more circumstances than has hitherto been the case, it advises directors to consider their fiduciary duties when making a distribution. In particular, directors should consider whether it is prudent to distribute profits arising from either an asset that is subject to volatility, or gains arising from assets and liabilities that are economic hedges where one is accounted for at fair value and the other is not. Consideration should be given to the immediate cash flow implications of a distribution and the continuing ability of the company to pay its debts as they fall due.

With respect to fair value losses, TECH 2/07 confirms that these will be realised where profits arising on the remeasurement of the same asset or liability would be treated as realised profits under TECH 2/07. Thus, fair value losses are generally realised. However, there are certain circumstances where fair value losses would not be realised. A common example is a loss which reverses a previous unrealised gain on, say, an investment property or unlisted investment. Furthermore, it is possible to recognise a cumulative loss on the remeasurement on certain assets (e.g., an investment property or unlisted investment) that does not result in impairment. Such a loss is unrealised – although an impairment *would* be a realised loss – because cumulative revaluation gains on those assets would be unrealised.

Hedge accounting

Hedge accounting can sometimes lead to more complicated issues and TECH 2/07 provides further guidance in this area.

Where fair value hedging is undertaken, the movements in both the hedged item and the hedging instrument will be taken to the income statement. In many cases, both legs will be realised by reference to the guidance in TECH 2/07 and no further consideration is required. However, where one leg may, absent consideration of the hedging aspect, be unrealised, a more detailed examination is required. Where a net loss arises, this loss will generally be treated as realised (subject to the guidance provided in TECH 2/07, as discussed above). For example, if a fair value hedge results in a realised loss of 100 on the hedging instrument and an unrealised gain of 90 on the hedged item, the net loss of 10 that arises from the hedge ineffectiveness is treated as a realised loss. Owing to the hedging relationship, the unrealised gain on the hedged item is offset against

the realised loss on the hedging instrument – i.e., the 90 unrealised gain cancels out 90 of the realised loss. Where a net gain arises, a similar exercise should be undertaken to determine if the net gain gives rise to a realised profit or unrealised profit.

When cash flow hedging takes place, the effective portion of the hedging instrument – either a gain or loss – is recognised in equity and recycled to the income statement or balance sheet at a later date. TECH 2/07 provides guidance that those gains and losses taken to equity under cash flow hedging are treated as unrealised until they are recycled.

Issues arising from IAS 32 and FRS 25

IAS 32 (FRS 25) *Financial Instruments: Presentation* often requires that financial instruments are presented on a basis that is different from their legal form – e.g., many preference shares are presented as debt rather than equity. However, at law such instruments are still shares, resulting in some important issues with respect to determining realised profits.

For example, IAS 32 requires the distributions and capital repayments on many preference shares to be presented as interest payable. Nevertheless, the legal status remains unchanged and, as a result, the advanced recognition of such amounts (say, by accruing interest for accounting purposes) does not lead to a consumption of distributable profits. Rather, distributable profits are consumed when the distribution is paid or declared, or the capital repayment is effected. However, the position of public companies is further complicated by the application of section 264 (the net assets test), which requires that a distribution must not reduce net assets below share capital and undistributable reserves. As a result, the accrued finance charge will cause a restriction in distributable reserves because net assets are reduced but share capital and undistributable reserves are unaffected.

There is also additional material setting out the principles for dealing with other IAS 32 issues such as compound instrument split accounting and options on own shares. This material is accompanied by eight detailed worked examples, which offer useful illustrations of how the guidance should be applied.

Other matters

TECH 2/07 also provides guidance on a number of other areas by showing how its and TECH 7/03's principles are applied. Two areas merit particular discussion. First, the credit arising from equity-settled share-based payments will normally be a realised profit provided that the equivalent debit entry has been treated as a realised loss. Where there is a commercial basis for inter-company recharges, this will not be a distribution as a matter of law. Second, under adopted IFRSs dividends received from pre-acquisition profits of subsidiaries must first be set against the cost of investment, which does not therefore result in the receipt of income and, to the extent that they are set against the cost of investment, cannot lead to realised profits unless there is a merger reserve (or similar) associated with the investment that is thereby realised.

TECH 2/07 is available at:

www.icaew.com/index.cfm?route=151003



Enhanced business review

The new requirements in the Companies Act 2006 (section 417) for the business review in the directors' report have been made effective for financial periods beginning on or after 1 October 2007. The business review requirements of the Companies Act 1985 (section 234ZZB) have been repealed for those financial periods.

The stated purpose of the 2006 Act's review is to inform members and help them assess how the directors have performed their duties to promote the success of the company. The 2006 Act's requirements with respect to the business review of quoted companies are more extensive than those of the 1985 Act (themselves introduced only in 2005), requiring:

- more forward-looking disclosure regarding the trends and factors likely to affect the future development, performance and position of the business;
- information about environmental matters, employees and social and community issues as well as policies and the effectiveness of any such policies in relation to these matters. If any of this information has not been given, a statement must be made to this effect; and
- information about persons with whom there are contractual or other arrangements which are essential to the business (the so-called "supply chain" disclosure requirements) but subject to limited exemption from disclosure where that disclosure would be both seriously prejudicial to that person and contrary to the public interest (we expect such cases to be extremely rare in practice).

A general exemption from disclosure is also provided in section 417 for any impending matters or matters in the course of negotiations where disclosure would be seriously prejudicial to the interests of the company (no such exemption was provided in the 1985 Act).

As noted in the next article, the directors' report, and thus the business review, is within the remit of the FRRP.

It is also worth noting that section 463 of the 2006 Act (the so-called "safe harbour" provision) became effective in relation to directors' reports sent to members on or after 20 January 2007. This sets out the basis of directors' liability to the company in relation to statements in the directors' report (and also in the directors' remuneration report and any summary financial statement derived from the directors' report or directors' remuneration report). The aim is to exclude the courts from developing a common law approach to directors' liability in relation to these reports that goes any further than this statutory provision. A director will be liable in relation only to statements that have proved untrue or misleading, on a "knowingly or recklessly" basis, or if the director knew that an omission was a dishonest concealment.



FRRP activity

In September 2007 the Financial Reporting Review Panel (FRRP) published a report on the results of its activity during the year ended 31 March 2007, a report on its follow-up review of pensions disclosures under IFRS and the criteria it intends to apply to its forthcoming reviews of directors' reports, including the enhanced business review.

Statistics

In 2006/07, the Panel reviewed 311 sets of accounts (2005/06: 284), including interims, and wrote letters to 135 companies (2005/06: 82) asking for further information about areas of possible non-compliance with the accounting requirements of the Companies Act 1985 or the Listing Rules.

Key messages from activity report

The report highlights improvements and corrections identified by the Panel in the course of its reviews and sets out a number of key messages to companies.

The Panel wrote letters to more than 43 percent of the companies whose accounts it reviewed. (The Panel wrote to 45 percent of FTSE 350 companies of whose accounts it reviewed compared with 57 percent of listed companies outside the FTSE 350.) It explained the high level of activity in relation to listed company accounts as a focussed attempt to challenge seemingly questionable IFRS accounting treatments and disclosures which appeared inadequate before they became established practice.

The Panel will follow up both on companies' response to the general messages in its report and on the matters specifically raised in its letters, where companies undertake to provide corrected or improved treatments or disclosures.

The areas of reporting to which the Panel drew attention in its preliminary report in December 2006 on first-time adoption of IFRS continue to feature in this report, namely:

- accounting policies should be thoughtful and tailored;
- non-boiler-plate disclosure of judgements and estimates;
- the disclosure of the effect of new standards and interpretations;
- factors giving rise to goodwill;
- goodwill impairment testing details;
- related party disclosures;
- additional lines in the income statement should be justifiable; and
- non-GAAP measures – these should not be misleading or given undue prominence, and should be reconciled.

The Panel noted that the requirement to disclose significant estimates and judgements (IAS 1: paragraphs 113 and 116) attracted more Panel questions and comment than any other aspect of IFRS or, indeed, any other standard.

We strongly encourage companies to consider the disclosures in their accounts in light of the FRRP's report, as it is likely that these areas will come under further scrutiny in the future.

Key messages from follow-up report on pensions disclosures

The Panel carried out a follow-up review on IFRS pension disclosures in the accounts of the same 20 companies whose IFRS pension disclosures it reviewed in 2006. The report included the following findings:

- Considerable improvement in disclosures about mortality assumptions and in the provision of sensitivity analysis.
- No discernible improvement in information about assets held within the funds, nor about how expected returns have been calculated.
- Limited improvement in disclosures about maturity of funds.
- Minor omissions made in 2005 were almost always repeated in 2006.

Extension of the scope of the FRRP's review to directors' reports, including the enhanced business review

The FRRP has started to review the directors' reports of public and large private companies, as well as their accounts. This brings the business review within the Panel's scope for the first time. The change applies to reports for accounting periods commencing on or after 1 April 2006.

The Panel has published the criteria to be applied in its review of directors' reports. In its consideration of business reviews, the Panel will take account of a number of factors, including whether:

- the directors' report contains an explicit cross-reference where the requirements of the review are met elsewhere in the report and accounts;
- the information in the business review is consistent with all other information included in the report and accounts;
- the information in the business review is consistent with that disclosed in the company's other announcements;
- the business review is balanced and comprehensive in the sense that it deals even-handedly with the positive and negative aspects of the development, performance and position of the business;
- the discussion of the risks and uncertainties facing the company identifies and describes the principal ones; and
- the business review includes appropriate key performance indicators.

The activity report, follow-up review of pension disclosures and the notice of scope extension are available at:

www.frc.org.uk/frrp/press



Net investment accounting under IAS 39

The International Financial Reporting Interpretations Committee (IFRIC) has issued draft interpretation D22 proposing clarification of net investment hedge accounting under IAS 39. The UK standards FRS 23 *The Effects of Changes in Foreign Exchange Rates* and FRS 26 *Financial Instruments: Recognition and Measurement* are converged with international standards and the UITF has therefore issued a draft abstract proposing changes to UK GAAP that would keep the standards in alignment. The UITF intends issuing the final version of the IFRIC's interpretation as an abstract but is inviting comments, particularly on the application of the proposals in the UK and Ireland.

The abstract would apply only to those companies reporting under UK GAAP and applying FRS 26 and FRS 23. There would be no impact on those applying SSAP 20 *Foreign currency translation*. The UITF proposes amending D22, in finalising it as a UK abstract, only to refer to UK rather than international standards.

The draft proposes confirming that the hedged risk must be the foreign exchange risk arising from movements in rates between the *functional* currencies of the foreign operation and any parent entity (i.e., not the parent's presentation currency).

It suggests that the hedging instrument may be held by any entity within the group, except the foreign operation that is being hedged, regardless of its functional currency.

The draft abstract is available at:

www.frc.org.uk/asb/uitf/pub1409.html

The deadline for comments was 9 November 2007.



IFRS newsletters

KPMG IFRG Limited has published the following since the August/September 2007 Update, which are available on our Web site at www.kpmg.co.uk:

IFRS in Brief:

- *August 2007* – A summary of the July 2007 meeting of the IASB
- *September 2007* – A summary of the September 2007 meeting of the IASB
- *October 2007* – A summary of the October 2007 meeting of the IASB

IFRS Briefing Sheets:

- Issue 74 – IAS 1 (revised) *Presentation of Financial Statements*
- Issue 75 – Exposure Draft *Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement – Exposures Qualifying for Hedge Accounting*
- Issue 76 – Exposure Draft *Joint Arrangements*
- Issue 77 – Exposure Draft *Proposed Improvements to International Financial Reporting Standards*
- Issue 78 – *IASB's Projects Overview*

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.

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