DISCUSSION PAPER

REPORTING FINANCIAL PERFORMANCE:

PROPOSALS FOR CHANGE

ACCOUNTING
STANDARDS
BOARD

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and should be dispatched so as to be received not later than 17 September 1999. All replies will be regarded as on the public record unless confidentiality is requested by the commentator.

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ACCOUNTING STANDARDS BOARD

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Contents

		page
FOREWORD BY THE ASB		**3**
G4+1 POSITION PAPER		**15**
Preface		**16**
G4+1 Memorandum of Understanding on Objectives		**17**
Executive summary		**19**
Invitation to comment and questions for respondents		**21**
Section 1	***Proposals for a standard on reporting financial performance***	**24**
Chapter 1	Introduction	24
Chapter 2	Proposed model for reporting financial performance	32
Chapter 3	The contents of 'other gains and losses'	41
Chapter 4	Recycling	51
Section 2	***Other issues***	**58**
Chapter 5	Unusual items	58
Chapter 6	Continuing activities, discontinued/ discontinuing activities and acquisitions	62
Chapter 7	Tax expense	65
Chapter 8	Changes of accounting policy	69
Chapter 9	Changes in estimates and corrections of errors	72

Summaries of existing practice of G4+1 members

Appendix A Reporting financial performance **77**

Appendix B Unusual items **81**

Appendix C Discontinued/discontinuing and continuing operations **85**

Appendix D Changes of accounting policy **90**

Appendix E Changes in estimates and corrections of errors **93**

FOREWORD BY THE ACCOUNTING STANDARDS BOARD

1 This Discussion Paper presents a Position Paper that has been developed by the G4+1 group of accounting standard-setters. It reflects an agreed approach to reporting financial performance that each body represented in the Group intends to develop in its own constituency, in most cases aiming towards an accounting standard or the revision of an existing standard.

2 This foreword indicates the main implications for reporting financial performance in the UK, and in particular the impact of the proposals on the existing standard on the subject, FRS 3 'Reporting Financial Performance', issued by the Accounting Standards Board in October 1992. The proposals in the Position Paper will be developed with the intention of revising FRS 3.

The recent history of reporting financial performance in the UK

3 SSAP 6 'Extraordinary items and prior year adjustments', which was superseded by FRS 3, was originally issued in 1974 and was based on the 'all-inclusive' concept of profit. It was revised in 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. It was clear that the 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.

4 Soon after it began its operations (in 1990) the Board responded by proposing a major change to the presentation of financial performance. These proposals eventually resulted in the issue of a standard, FRS 3 'Reporting Financial Performance', in 1992.

5 One of the implicit objectives of SSAP 6 was to provide summary performance measures that would be useful for a wide range of purposes. However, it was widely accepted that certain totals in the profit and loss account, such as profit after tax, had been used too simplistically and had obscured the significance of relevant underlying components of financial performance. The Board believed (as it still does) that the performance of complex organisations cannot be summarised in a single number and FRS 3 therefore was based on an 'information set' approach that was designed to highlight a number of components of performance within a framework that facilitated the analysis and interpretation of the various aspects of performance.

6 When the Board issued FRS 3, it stated that it would be for users to identify particular components that they regarded as significant in varying circumstances. The Board believed that it was not appropriate for users to pay particular attention to any single number without considering its composition, relevance and relationship to other aspects of financial performance. Using the information required by FRS 3, users were enabled to make their own assessments of an entity's financial performance. The Board believes that FRS 3 was an important step forward, assisting a more mature understanding and analysis of financial performance.

The need for change

7 In its 'Foreword to Accounting Standards', the Board states that:

> "33 Accounting standards are issued against the background of a business environment that evolves over time. The Board is, therefore, receptive to comments on accounting standards, recognising that, for some, a substantial period may be needed before their effectiveness can be judged, while in other cases there may be special reasons why an earlier review is necessary. However, the Board believes that it will normally be appropriate to allow new accounting standards a period in which to become established before commencing a process of formal post-issue review."

8 FRS 3 was groundbreaking in its time and still represents a more sophisticated approach to reporting financial performance than that found in most countries. Nevertheless, since it first came into force there have developed in the UK various practices in the application of FRS 3 and perceptions about some of its requirements that indicate a review of the standard would be timely. Some of these are investigated in the Position Paper.

9 In addition, certain other countries have to some extent been moving towards the UK approach to reporting financial performance. It was therefore thought desirable to conduct at least the initial phase of the review of the standard at an international level, in order to encourage harmonisation and to share the views of the international accounting community.

A summary of the impact of the main proposals on FRS 3

A single performance statement

10 One of the most important innovations of FRS 3 was the introduction of the statement of total recognised gains and losses (STRGL). Previously, because certain items of financial performance were not included in the income statement, they had tended to be 'lost' in equity (reserve) movements. FRS 3 did not attempt to change practice in the case of those items that the law or earlier accounting standards permitted to be taken to reserves, but it did ensure that such gains and losses were reported as such in a primary statement of financial performance.

11 The Position Paper seeks to build on the position achieved by FRS 3, broadly by adding the information at present contained in the STRGL to the foot of the profit and loss account, with the result that there would be a single performance statement showing all changes in equity, other than transactions with shareholders. The single statement would show the full analysis of financial performance with three main components:

(a) the results of operating (or trading) activities;

(b) the results of financing and other treasury activities; and

(c) other gains and losses.

12 In broad terms, the first two components comprise the items that at present are reported in the profit and loss account, while the third would report those that are reported in the STRGL: however, some changes are proposed.

Other changes to FRS 3

13 The Position Paper proposes to retain many of the features introduced by FRS 3:

(a) the definition and treatment of extraordinary and many exceptional items;

(b) the analysis of operating results into continuing and discontinued activities;

(c) the treatment of changes in accounting policy; and

(d) the treatment of changes in estimate.

14 The Paper does, however, make certain proposals that develop the existing features of FRS 3.

(a) Its proposals would change the treatment of those items that, in accordance with paragraph 20 of FRS 3, are shown separately after operating profit: profits and losses on the sale or termination of a business and on the disposal of fixed assets would generally be reported within the 'other' section of the statement, while costs of a fundamental reorganisation or restructuring would be reported as part of operations, albeit, if material, separately disclosed.

(b) The Paper calls for an additional disclosure to put in context presentations of 'pre-exceptional results', which are sometimes made on a voluntary basis. The proposals would neither encourage nor prohibit such presentations but, where they are made, they should be accompanied by disclosure of pre-exceptional results, exceptionals and post-exceptional results for each of the past, say, five years. In many cases such disclosures will show that, while arising for different reasons in each period, exceptional items cannot reasonably be ignored when assessing the trend of results.

(c) The allocation of tax across different components of financial performance, an issue in the FRED that preceded FRS 3, is also addressed in the Paper.

(d) The proposals in the Paper would express somewhat differently from UK standards the treatment of the correction of errors that are discovered after the financial statements have been issued. In the Paper no distinction is made between 'fundamental errors' as defined by FRS 3 and any other material errors; consequently all material errors would require correction by means of a prior period adjustment. The view of the G4+1 is that it would not be practicable to distinguish fundamental from material errors. This approach would leave the current year profit uncorrupted by errors of the past; nevertheless the constant correction of material errors would cast some doubt on the efficiency of preparers and auditors.

15 The Position Paper, in a series of appendices, compares and contrasts the approach to various aspects of reporting financial performance in different jurisdictions.

Proposed changes to FRS 11 'Impairment of Fixed Assets and Goodwill' and FRS 15 'Tangible Fixed Assets'

16 Chapter 3 of the Position Paper describes how gains and losses relating to fixed assets would be reported in a single statement of financial performance. Both FRS 11 and FRS 15 adopt the 'value to the business' model and both recognise that 'revaluation losses' may be due in part to a general fall in prices and in part to a consumption of economic benefits and that it is not always possible to determine which has caused a fall in value. The solution offered in FRS 11 (that losses should be reported according to the extent to which they reduce carrying value to or beyond depreciated historical cost—an arbitrary cut-off line) can be seen as a pragmatic response to the lack of a framework for reporting gains and losses with different characteristics. FRS 15 developed a more principled approach. The Position Paper takes this approach a stage further and introduces an evolution in reporting practice by proposing a framework for reporting financial performance that would minimise the need to resort to arbitrary rules.

17 The Position Paper proposes three changes to present practice in the UK:

(a) Disposal gains that do not represent adjustments to depreciation or reversals of impairments would be reported in the 'other gains and losses' section of a single performance statement (broadly equivalent to the STRGL). Under FRS 15 they are reported in the equivalent of 'operating/trading activities' (ie the profit and loss account), although shown separately on the face of the profit and loss account (FRS 3, paragraph 20).

(b) To the extent that they do not represent impairments or adjustments to depreciation, disposal losses would be reported in the 'other gains and losses' section of a single performance statement. Under FRS 15 they are reported in the equivalent of 'operating/trading activities' (ie the profit and loss account), although shown separately on the face of the profit and loss account (FRS 3, paragraph 20).

(c) All impairment losses would be reported in the 'operating/trading activities' section of a single performance statement. Under FRS 11 impairment losses arising on revalued fixed assets are reported in the STRGL (broadly equivalent to the 'other gains and losses' section of a single performance statement) to the extent that they do not reduce the carrying value of the asset to below depreciated historical cost and are not caused by a clear consumption of economic benefits.

18 These changes extend the approach taken in FRS 15 to revaluation losses, which may be reported in the STRGL to the extent that the recoverable amount of the asset is greater than its revalued amount (such losses not representing an impairment but rather a downward revaluation).

19 The following table summarises how gains and losses on fixed assets would be reported under the value to the business model according to the Position Paper.

Component of performance	**Gains and losses**
Operating/ trading	**Depreciation** based on carrying value All **impairment losses** (and their reversal) **Disposal gains/losses** representing adjustments to depreciation **Disposal losses** that are impairments
Other gains and losses	**Revaluation gains** **Disposal gains** that do not represent adjustments to depreciation or reversals of impairments **Revaluation and disposal losses**: extent to which there has been no impairment or adjustment to depreciation

20 These changes reflect the development of the components approach to reporting financial performance whereby gains and losses are grouped together according to their nature rather than an approach based on realisation.

UK issues not addressed in the Position Paper

Legal issues

21 As the proposals in the Position Paper have been developed in an international context, the Paper does not address the legal issues that would require consideration if the proposals were to be implemented as a standard in the UK. These issues will be addressed in a future exposure draft of a standard that proposes a revision to FRS 3.

Dividends

22 In the UK, dividends (paid or both paid and proposed) are included on the face of the income statement as a deduction from profit for the year. In terms of reporting financial performance, as described in this Paper, dividends are an appropriation of profit, which should not be included in a statement of financial performance. It is therefore proposed that dividends should not be included on the face of the performance statement, but rather as part of changes in equity. The outflow of funds is also, of course, reflected (and separately disclosed) in the cash flow statement. If it is felt that users would still benefit from seeing the dividend for the year in relation to financial performance, it could be shown as a memorandum item, immediately following the performance statement. The treatment of dividends in the performance statement complements the decision that has recently been taken by IASC that a dividend declared after the year-end but before the financial statements are approved does not represent a liability at the balance sheet date, but rather an appropriation and should be so reported.

23 In the UK and the Republic of Ireland, companies legislation requires dividends for the period to be disclosed on the face of the profit and loss account. As noted above, this, along with other legal matters, will be addressed in the exposure draft that is developed as a result of the response to this Discussion Paper.

Review of responses and development of a standard

24 Publication of the Position Paper in other G4+1 jurisdictions will allow the Board to bring broader considerations into play when developing these proposals further. Members of the G4+1 will share information on national responses, although any work to develop standards after the publication of the Position Paper will be a matter for each individual jurisdiction.

Questions on reporting financial performance of relevance to the UK

25 Some of the questions raised within the Position Paper are of less relevance to the UK than other countries because some of the changes introduced by FRS 3 (and proposed in the Paper) have not yet been implemented in other countries. In particular, question 6(a) asks whether respondents agree that the concept of extraordinary items should be discarded. This was effected in the UK by the introduction of FRS 3 and so is of more relevance to those other members of the G4+1 who at present permit the use of extraordinary items. Similarly, questions on the proposals for the treatment of changes of accounting policy and changes in estimates are likely to be uncontroversial as they reflect current UK practice.

26 In contrast to such questions, there are certain aspects of reporting financial performance that are of relevance only in the context of the UK and the Republic of Ireland. These could not be included in the Position Paper, but are raised here (the numbering of the questions in the Position Paper is continued here for the convenience of respondents) and comments by UK and Republic of Ireland respondents on these questions would be particularly welcome. It would be helpful if respondents could support their views with reasons and, where applicable, preferred alternatives.

Q11 Do you agree that dividends are not items of financial performance, but rather appropriations of profit that should not be included on the face of a single performance statement? If so, would it be useful to show dividends at the foot of the performance statement as a memorandum item?

Q12 FRS 3 requires the disclosure of a note of historical cost profits and losses. This was introduced to aid comparability while discretion was available on the revaluation of fixed assets and to allow users to assess the profit or loss on the sale of a fixed asset by reference to its historical cost. Should a note of historical cost gains and losses be required in a revised standard? If so, should the role of this note be changed in any way?

Q13 Do you agree with the proposals in the Paper that all material errors discovered after the issue of the financial statements should be corrected by prior period adjustment, rather than restricting this treatment to 'fundamental errors' as defined by FRS 3?

Q14 Do you believe that the proposals in the Paper on how gains and losses on fixed assets should be reported represent a useful development of the rules introduced by FRS 11 and refined by FRS 15? In particular, do you agree with the proposals for reporting impairment and other losses?

G4+1 POSITION PAPER

Reporting Financial Performance: proposals for change

Australian Accounting Standards Board
Canadian Accounting Standards Board
International Accounting Standards Committee
New Zealand Financial Reporting Standards Board
United Kingdom Accounting Standards Board
United States Financial Accounting Standards Board

PREFACE

This Position Paper resulted from the efforts of a Working Group consisting of Board members and senior staff members of the standard-setting bodies of Australia, Canada, New Zealand, the UK and the USA, and staff of the International Accounting Standards Committee (IASC). It is the second Position Paper issued by the G4+1 and was prepared to encourage standard-setters to achieve convergence in their standards on reporting financial performance. While members of the Working Group represented the standard-setting bodies with which they were affiliated, the views they expressed were their own and had not been officially deliberated by the bodies themselves.

The principal author is Kathryn Cearns, a project director on the staff of the UK Accounting Standards Board. Other ASB staff members as well as staff members of other G4+1 organisations also assisted in the preparation of the Position Paper.

G4+1 MEMORANDUM OF UNDERSTANDING ON OBJECTIVES (Revised March 1999)

Shared Objectives of Member Organisations

G4+1 organisations share an objective of providing quality financial reporting standards for the primary purpose of providing information useful to capital market participants.

G4+1 organisations share an objective of seeking common solutions to financial reporting issues. A single, quality financial reporting approach is more useful to capital market participants than multiple approaches.

G4+1 organisations share the view that financial reporting standards should be based on a conceptual framework. It follows that membership of the Group requires acceptance of a conceptual framework similar to that of other members.

G4+1 organisations share the view that seeking common solutions to financial reporting issues requires members to have the willingness and ability to commit resources to the resolution of those issues within the context of a conceptual framework.

G4+1 Objectives

G4+1 organisations seek to further their shared objectives through analyses and discussions of financial reporting issues. Those analyses and discussions help participants from member organisations develop a common understanding of the issues, a common language and tools for discussing and analysing the issues, and an understanding of the views and constraints in each others' jurisdictions.

G4+1 organisations seek to learn more about the timing and approach of standard-setting agenda projects in other jurisdictions. That knowledge can help them identify and take advantage of opportunities to coordinate their efforts and thereby further their shared objectives.

G4+1 organisations seek to further their shared objectives by exchanging new ideas and approaches to financial reporting issues and standard-setting processes that can be applied in their own jurisdictions.

G4+1 organisations seek to further their shared objectives by pursuing projects that have the potential to bring about convergence of financial reporting standards across member jurisdictions at a high level of quality.

EXECUTIVE SUMMARY

This Position Paper has been developed by the G4+1* group of accounting standard-setters. It reflects an agreed approach to reporting financial performance that each body represented in the Group intends to consider in its own constituency, in most cases aiming towards an accounting standard.

The G4+1, as part of its contribution to the debate on reporting financial performance, produced a Special Report 'Reporting Financial Performance: Current Practice and Future Developments' in January 1998. The Report examined the broad range of current and possible future practice and tentatively proposed an approach that might be adopted for reporting financial performance. This Paper represents the next stage of development in reporting financial performance and contains some firm proposals on the best way forward.

To help in deciding which component items of financial performance should be reported, the G4+1 Special Report (and subsequent discussions) considered:

(a) research about the information that users apparently find useful;

(b) recommendations from user groups on the information that they find useful;

(c) evidence provided by classification dichotomies that have been suggested by users and standard-setters; and

(d) advice from preparers on how they regard various components of 'performance'.

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* *The G4+1 comprises members of the standard-setting bodies from Australia, Canada, New Zealand, the UK and the USA. Representatives of IASC attend as observers.*

The conclusion reached by the G4+1 was that financial performance should be reported in a single performance statement, which should comprise three major components:

(a) the results of operating (or trading) activities;

(b) the results of financing and other treasury activities; and

(c) other gains and losses.

Overview of contents

Section 1 of this Paper proposes that all recognised gains and losses (including revenue and expenses) should be reported in a single performance statement. This approach to reporting is variously referred to as 'total gains and losses' or 'comprehensive income'. Chapter 1 reviews the characteristics of financial performance that are most helpful for users of financial statements, and looks briefly at the similarities and differences between the reporting of financial performance in the G4+1 constituencies. Chapter 2 considers whether financial performance is best reported in one statement or two, then lays out the overall proposals of this Paper for a single statement of financial performance. Chapters 3 and 4 look at two important areas: the possible contents of one section of the performance statement, the 'other gains and losses' section, and the issue of recycling gains and losses recorded in one section of the statement to another at a later period (the role of realisation in financial reporting is a key element of this discussion).

The approach described in this Paper would involve substantial changes to the income statement formats used by most reporting entities. Section 2 of the Paper looks at some of the consequential issues arising from this change and at various other aspects of reporting financial performance.

INVITATION TO COMMENT AND QUESTIONS FOR RESPONDENTS

The G4+1 welcomes comments on any aspect of the Position Paper. Respondents' views are especially sought on the matters set out below. It would be helpful if respondents could support their views with reasons and, where applicable, preferred alternatives.

Q1 Do you agree with the Group's conclusion in Chapter 2 that financial performance should be presented in one statement rather than two or more statements?

Q2 Do you agree with the proposed structure of a single statement of financial performance divided into the following three components:

(a) the results of operating (or trading) activities;

(b) the results of financing and other treasury activities; and

(c) other gains and losses?

If you do not agree, can you suggest a division that would be more useful? Please give reasons for preferring your alternative.

Q3 Do you agree with the matrix, shown in paragraph 2.12, that would be used as the basis for allocating items of recognised financial performance between operations and other gains and losses?

Q4 Chapter 3 looks at how the matrix would be used to allocate items to components. Do you agree with the way the matrix has been applied to:

(a) foreign currency translation adjustments; and

(b) changes in the value of fixed assets?

Q5 Chapter 4 discusses whether recycling between the different components of the statement should be permitted. Do you agree with the conclusion that recycling should not generally be permitted?

Q6 Chapter 5 discusses unusual, abnormal and exceptional items.

(a) Do you agree with discarding the concept of extraordinary items?

(b) Do you agree that abnormal/exceptional items should not be reported as a separate category of revenues and expenses?

(c) Do you think that entities should be required to disclose trends over time in a historical summary to highlight any pattern of reporting abnormal/exceptional items?

Q7 Chapter 6 examines how discontinuing and continuing information could be disclosed within the statement of financial performance.

(a) Do you agree that information of this nature is useful?

(b) Do you think that discontinued activities should be classified as such only when the decision to discontinue is irrevocable?

(c) Would you prefer to see such information on the face of the statement or is disclosure by note sufficient?

Q8 Chapter 7 covers the allocation of tax expense to the components of the statement of financial performance. Do you agree with the proposal that tax expense should be allocated only to (i) the total of operating and financing activities and (ii) 'other gains and losses' (with additional disclosure of the tax related to individual items in 'other gains and losses')? If not, please indicate which of the alternatives referred to in the chapter you support, and why.

Q9 Chapter 8 looks at the accounting treatment of voluntary changes in accounting policy. Do you agree with the proposed treatment of such changes as prior period adjustments, ie retrospective application with restatement of prior periods?

Q10 Chapter 9 examines the treatment of changes in estimates and the correction of errors.

(a) Do you agree that changes in estimates should be reported in the period in which the change is made?

(b) Do you agree that material errors should be treated as prior period adjustments, ie retrospective application with restatement of prior periods?

SECTION 1: PROPOSALS FOR A STANDARD ON REPORTING FINANCIAL PERFORMANCE

Chapter 1 Introduction

1.1 How well an entity performs in financial terms is important to all those associated with it, whether as potential or existing investors, creditors, employees or managers. With differing information needs and purposes, each interested party should be provided with data that is comprehensive, relevant and reliable, so as to allow an informed opinion to be reached on the entity's financial performance. The (apparently) straightforward question: 'How well has this company performed during this period?' is generally a precursor to a host of other more detailed questions arising from the need to gain further insights into the information presented. This is hardly surprising and merely reflects the present inability of financial reporting to represent adequately the economic effects of all the events affecting the entity.

1.2 In recent years various difficulties have arisen in reporting certain items of financial performance (discussed further below). As standard-setters have tackled these problems, more general questions have arisen about the scope of financial performance and how it should be reported. For many standard-setters, the stage has now been reached where a full and informed debate of these issues would be of benefit. Not only would this assist in reaching decisions about the reporting of certain items in the financial statements, it would also address the wider question of the best way to report financial performance.

1.3 This Paper does not attempt to provide a definitive answer to the question of what constitutes financial performance. Rather, it seeks a framework within which financial reporting can develop to satisfy the increasing demands being made upon it.

1.4 There are, nevertheless, some pertinent comments that can be made about financial performance and how it should be reported.

(a) Items of financial performance should be reported when the items have met the recognition criteria specified in accounting standards. This does not necessarily mean that all items of financial performance will be recognised; only those that are capable of representation in the financial statements under the existing model, as dictated by prevailing accounting standards, will be recognised.

(b) Transactions between the entity and its owners are not part of financial performance. Rather, these relate to the funding of the entity and its distribution policy.

(c) Within financial performance, separate classification of items that demonstrate different characteristics provides useful information, for example items arising from the financing of the entity should be separated from items arising from its operating activities. The usefulness of the information will be enhanced if all items are categorised in a consistent and transparent manner.

The role of reporting financial performance: predictive value

1.5 Users of financial statements require information on the entity's financial performance because such information:

(a) assists users in assessing the capacity of the entity to generate cash flows from its existing resource base and in forming judgements about the effectiveness with which the entity has employed its resources and might employ additional resources; and

(b) provides feedback to users so that they can review their previous assessments of the financial performance for past periods and can modify their assessments for, or develop expectations about, future periods.

1.6 In summary, a key objective of financial reporting is to provide information that is useful in making predictions (and in confirming or correcting previous predictions) of the amount, probability and timing of future cash flows. This is sometimes expressed by saying that the information contained in financial statements has 'predictive value'.* The usefulness of financial statements is enhanced if the predictive value of the information they contain is increased.

1.7 'Bottom line' figures (for example, profit or loss for the period) and similar high-level summary measures of financial performance often have little predictive value because they represent the aggregate of a large number of dissimilar items. Because these different items will respond differently to changes in the economic environment, it is not possible to make reliable assessments about future financial performance solely on the basis of the aggregate. Whilst an attempt to improve the usefulness of a 'bottom line' figure may be made by adjusting for unusual items, such crude adjustments cannot provide a measure that is a reliable basis for the assessment of past and future performance: for such assessments it is necessary to have information about the components that the total comprises.

1.8 Reporting the components of financial performance entails a description of the components as well as disclosure of their amounts. It follows that providing information on the components of financial performance assists users not only to make predictions about future financial performance, but also to assess the relative significance of each component in terms of reliability and stability. A familiar example of the way in which financial statements seek to meet this need in present practice is through the provision of segmental (or disaggregated) information.

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* *As noted in FASB Concepts Statement No. 2 (paragraph 53), to say that accounting information has predictive value is not to say that it is itself a prediction. It should also be understood that financial statements do not seek to provide all the information that users need to make assessments of future financial performance.*

1.9 Some items of financial information may have significant predictive value despite volatility in different reporting periods. For volatile items to retain predictive value, users require information on the nature of the volatile item and results for several reporting periods.

1.10 In principle, all gains and losses (these terms are used here to encompass all types of gain and loss, including revenue/income and expenses/costs) are relevant to an understanding of financial performance, although the significance of each gain or loss will vary according to its individual characteristics. For example, the gain made by a manufacturing company on the revaluation or disposal of its factory has different significance from the trading profit it makes from manufacturing and selling, say, washing machines. In contrast, for an investment property company, the gains and losses arising on its portfolio of properties will be much closer in nature to trading profits, because they represent an actively managed part of the business.

Existing problems in reporting financial performance

Exclusion of relevant items from the statement of financial performance

1.11 On occasion, accounting has responded to new financial reporting challenges by recognising certain changes in net assets but excluding them from the income statement. For example, foreign currency translation adjustments arising on the net investment in foreign operations are recognised directly in equity in many jurisdictions. This has enabled one aspect of the event to be highlighted without disturbing the traditional presentation of the income statement. The result has been that, although the effect of the event on net assets is shown clearly, the change itself (ie the gain or loss) is not disclosed as an aspect of financial performance. Because these items of financial performance are not included in the income statement, they tend to be obscured in equity (reserve) movements.

1.12 Some standard-setters have mitigated this problem by introducing a second performance statement that shows *all* gains and losses recognised during the period (other than those arising from transactions with owners in their capacity as owners). The income statement feeds into this second statement, as it shows the profit or loss for the period as one component of total gains and losses. In contrast, other standard-setters have required additional or more prominent disclosure of certain movements in equity (reserves) that reflect items of financial performance. The members of the G4+1 agree, however, that all components of recognised performance should be reported and described as components of performance, rather than being reported alongside changes in equity resulting from contributions by or distributions to the entity's owners.

Inclusion of inappropriate items within financial performance

1.13 The question of what constitutes financial performance is not always easy to answer. There are, however, certain items that are frequently reported as a part of financial performance, without real justification. For example, in many jurisdictions, dividends (paid or both paid and proposed) are shown on the face of the income statement as a deduction from profit for the year (indeed, this is required by law in some jurisdictions). In terms of reporting financial performance as described in this Paper, however, dividends are an appropriation of profit, not an item of financial performance. Dividends represent transactions with owners in their capacity as owners and so should be excluded from the statement of financial performance.

Inappropriate classification bases

1.14 The increasing sophistication of the business environment means that traditional distinctions such as realisation have become an inadequate basis for determining where and how items of financial performance should be reported. Basing the reporting of items of performance on the realisation of assets (particularly assets that have a liquid market) permits the

management of reported profits. Realisation is reflected in the cash flow statement, but cash flows reflect only certain aspects of performance (which may be those most susceptible to management discretion). No matter how extensive the disclosure of cash flow information, it merely gives information about liquidity and historical realisation into cash (or amounts close to cash), but not about financial performance. The role of realisation in performance reporting is discussed further in Chapter 4.

A comparison of current practices

1.15 A summary of existing practice in reporting financial performance by the standard-setters represented in the G4+1 is given in Appendix A. This reveals both similarities and differences in the way these standard-setters have approached the issue. The significant differences between the approaches have raised the following questions in particular, all of which are addressed in this Paper.

(a) In what form should recognised items of financial performance be reported? In particular, should all such items be reported in a single statement of financial performance or should some be reported in a statement of movements in owners' equity (shareholders' funds) that includes items that do not represent financial performance (see Chapter 2)?

(b) What categories should be used to report items of financial performance (see Chapter 2) and how should items be allocated to these different categories or components (see Chapter 3)?

(c) Should items of financial performance that initially are reported outside the statement of financial performance be 'recycled' into it later (see Chapter 4)?

1.16 The main effect of many existing (and proposed) standards* has been that it is now widely recognised that the reporting of all recognised gains and losses in a performance statement or statements can alert users to significant aspects of an entity's interaction with its economic environment. The international consensus is thereby moving towards reporting items of performance separately from items that do *not* represent financial performance.

1.17 There are also indications in existing practices of the direction that might be taken to resolve common deficiencies by introducing a consistent approach to reporting financial performance. Although the UK standard (FRS 3 'Reporting Financial Performance') is the only standard among G4+1 members that *requires* all components of financial performance to be presented in a primary statement of financial performance, this is an option in the US standard, FAS 130 'Reporting Comprehensive Income', and in the IASC standard, IAS 1 (revised) 'Presentation of Financial Statements' and is proposed in the Australian Exposure Draft ED 93 'Statement of Financial Performance and Ancillary Amendments'. Moreover, FAS 130 (paragraph 67) states that:

> "The Board believes that displaying comprehensive income in an income-statement-type format is more consistent with the Concepts Statements and therefore is conceptually superior to displaying it in a statement of changes in equity."

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* *FRS 3 in the UK, FRS-2 in New Zealand, FAS 130 in the USA, IASC's IAS 1 (revised) and Australia's ED 93: see Appendix A for details.*

Conclusion

1.18 It is incumbent on national and international standard-setters to find a way of reporting financial performance that allows an orderly analysis of voluminous and complicated information, so that users can gain a better understanding of an entity's underlying performance. The concept that a single summary figure cannot fully convey financial performance is a key aspect of the approach to reporting financial performance advocated in this Paper. The components of financial performance are important; this Position Paper seeks to identify the different characteristics of those components in order to show how items are likely to be grouped within them. Only by assessing all relevant components can users gain a clear insight into past performance and be well placed to estimate likely future trends.

1.19 Many of the most difficult and controversial projects currently under consideration by standard-setters both nationally and internationally are affected by this project. It is hoped that progress on a new standard on reporting financial performance will contribute to the resolution of issues not dealt with in this document because they form part of other projects, the most notable of which is the financial instruments project.

Chapter 2 Proposed model for reporting financial performance

2.1 As noted in Chapter 1, some standard-setters have adopted a second performance statement, in addition to the income statement. This second statement usually shows the *total* gains and losses recognised during the period. This requires the presentation of certain gains and losses as items of financial performance, even though they are excluded from the income statement. The net profit or loss for the period as shown in the income statement is incorporated in the second statement (as part of the total gains and losses recognised).

Reporting financial performance in one statement or two

2.2 Some argue that reporting by means of two statements may enable reporting entities to provide more detail about financial performance than they could in only one statement, particularly if it is thought that the number of line items that an individual statement ought to contain should be limited. However, the level of detail to be presented in financial statements has, in some countries, traditionally been left to the discretion of reporting entities to a considerable extent. It might appear to some, therefore, to be similarly appropriate to leave the decision about whether to report in one statement or two to their discretion.

2.3 The issue of whether to report financial performance in one statement or two may be a pragmatic matter rather than a conceptual one, where one of those statements is all-inclusive and summarises all aspects of financial performance recognised during the period. This is the approach taken in FRS 3 in the UK, with the income statement feeding into an all-inclusive statement. This approach goes some way towards a clearer presentation of the impact of transactions and other events on financial performance, completing the picture given in the income statement by drawing together all recognised gains and losses. There is an added practical advantage to this approach, which is that the second statement improves financial reporting without disrupting the existing income statement.

2.4 A significant drawback to the two-statement approach is that undue significance may be attached to one statement at the expense of the other (as has been the experience in the UK), and greater significance may be given to the distinction between the two statements than is justified.

2.5 Given these considerations, the G4+1 came to the conclusion that it is appropriate for all financial performance to be reported in a single expanded statement of financial performance rather than in two statements.

2.6 The G4+1 furthermore concluded that financial performance should be reported in three major components:

(a) the results of operating (or trading) activities;

(b) the results of financing and other treasury activities; and

(c) other gains and losses.

The Group recognises that ‘operating activities’ is not an ideal term for characterising the differences between items included in the first component and items in the third, but has adopted it because of its prevalence in existing practice.

2.7 The following is a summarised version of such a performance statement for a ‘typical’ manufacturing entity, drawn up as a single statement divided into three components.

STATEMENT OF FINANCIAL PERFORMANCE

OPERATING (TRADING) ACTIVITIES		
Revenues		775
Cost of sales		(620)
Other expenses		(104)
Operating income		**51**
FINANCING AND OTHER TREASURY ACTIVITIES (note 2)		
Interest on debt	(26)	
Gains and losses on financial instruments	8	
Financing income		**(18)**
Operating and financing income before taxation		**33**
Taxation on income		(12)
Operating and financing income after taxation		**21**
OTHER GAINS AND LOSSES		
Profit on disposal of discontinued operations	3	
Profit on sale of properties in continuing operations	6	
Revaluation of long-term assets	4	
Exchange translation differences on foreign currency net investments	(2)	
Other gains and losses before taxation	**11**	
Taxation on other gains and losses	(4)	
Other gains and losses after taxation		**7**
Total (note 3) **[Increase (decrease) in equity other than from contributions by or distributions to owners]**		**28**

Notes

1. All three components of the statement can be broken down into subcomponents of continuing activities, acquisitions and discontinued activities, shown either on the face of the statement or by way of a note: see Section 2, Chapter 6.
2. For entities operating in certain industries, such as banking and finance, this component could be merged with 'operating/trading'.
3. The 'total' may be described in other ways, for example as 'comprehensive income' (USA) or as 'total recognised gains and losses' (UK).

2.8 In total, the first two components of this statement are very close to the existing income statement in many jurisdictions. The 'other gains and losses' section contains many of the items that are shown in a second performance statement in some jurisdictions, or within movements in equity in others. The separation of items into three broad categories (operating, financing and other) is already in practice in several countries, such as France, Italy and Spain. In France, for example, the third category is called 'exceptionnel', whose significance is not directly equivalent to the way the terms 'exceptional', 'unusual' or 'extraordinary' are used in many of the G4+1 member constituencies. In the three countries noted above, the profit on the sale of fixed assets would currently be treated as 'other'.

Reporting items with different characteristics

'Operating activities' vs 'other gains and losses'

2.9 One of the most controversial issues in reporting financial performance is the classification of items into operating activities and other gains and losses. For most entities, many items of financial performance would clearly be reported within operating activities—sales, cost of sales and general overheads are obvious examples. Whilst trading income may fluctuate from one period to the next, its components are generally central to the activities of the entity, in a sense that the effects of some events external to the entity—for example a loss on a net investment in a foreign subsidiary that is caused by changes in foreign exchange rates—are not. For that reason, the result of operating activities in one period is generally useful in predicting those results for following periods.

2.10 More specifically, the effect of price changes on assets and liabilities is often remote from the day-to-day activities of the entity. For example, changes in the value of a manufacturer's factory properties may have little immediate relevance for the profitability of the manufacturing business. Clearly, there is some opportunity for the manufacturer to maximise the possibility of gains and minimise that of losses of its factory properties through active management, but gains and losses caused by changes in

property prices have a different significance from the results of operating activities and would be used quite differently in constructing predictions of the entity's future prospects. Traditionally, it has been considered helpful to users to report these gains and losses separately from the results of operations.

2.11 In contrast, to the extent that holding gains or losses* relate to assets and liabilities that are held mainly with a view to benefiting from changes in their value, it would be appropriate to include them in operating activities, because active management of those assets and liabilities is one of the operating activities of the entity. Examples of such gains and losses would be those arising on short-term investments and on commodities actively traded by the reporting entity.

2.12 In summary, based on the traditional approach to financial reporting, those items that would be reported in operations share similar characteristics, as do those that would be reported as other gains and losses. The characteristics typical of each group may be arrayed as follows:

Characteristics more typical of operating items	**Characteristics more typical of other gains and losses**
Operating activities	Non-operating activities
Recurring	Non-recurring
Non-holding items	Holding items
Internal events (eg value adding activities)	External events (eg price changes)

* *Holding gains and losses arise from price changes during the time that an asset or liability is held by the reporting entity. They do not include profits or losses arising from the use of that asset or liability.*

2.13 It is not suggested that any one line in the above table should be used as a classification criterion to the exclusion of the others. Rather, items that predominantly have the characteristics listed on the left would tend to be reported as part of operating activities, and conversely those whose characteristics were predominantly those listed on the right would be reported as 'other gains and losses'.

2.14 In making this classification, items that share the characteristics listed in the left-hand column are sometimes described as 'revenues and expenses'; while those with the characteristics in the right-hand column are sometimes described as 'gains and losses'. For example, the FASB defines 'revenues and expenses' in terms of activities that constitute the entity's ongoing major central operations and 'gains and losses' as arising from peripheral or incidental transactions.*

2.15 In summary, the G4+1 proposes that those items actively managed to add value to the entity should be shown in operating or financing activities, while the economic impact of changes affecting peripheral aspects of an activity should be shown in 'other gains and losses'.

'Financing/treasury'

2.16 The contents of the 'financing/treasury' component of the statement of financial performance are not addressed in depth in this Paper, because they are likely to be determined by the financial instruments project that is underway at an international level. The financing activities component is likely to include some items that reflect characteristics similar to those of 'operating' items, and others that possess characteristics closer to items included in 'other gains and losses'. Interest expense is a possible candidate for inclusion in financing activities; other possibilities include gains and losses on derivatives and other financial instruments. Any discussion about the contents of this section is therefore, of necessity, very tentative.

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* *Statement of Financial Accounting Concepts No.6 'Elements of Financial Statements', paragraphs 78-89.*

2.17 For certain entities, particularly financial institutions, the 'financing and other treasury activities' component will consist of items that are actively traded as part of the core operations of the entity. In such cases the 'financing and other treasury activities' component should become a segment of 'operating (trading) activities'. This would present a more relevant reflection of the nature of operations for such entities.

How such an approach might be implemented

2.18 One of the difficulties in reporting financial performance is the degree to which strict regulation is appropriate. It is generally useful for users of financial statements to be able to see the financial performance of a business from management's perspective; overregulation can hamper management in telling its own story and thus make the financial statements less useful.

2.19 On the other hand, one of the essential features that make financial statements useful is the ability to compare the financial statements of different entities: this makes a degree of regulation essential. It was suggested above that no single characteristic would be relied on to demarcate operating activities from 'other gains and losses', but rather a number of characteristics needed to be considered together. This makes applying the distinction inevitably subjective to a degree and prone to practical difficulties. However, if each entity were permitted to decide the component in which each item were to be reported, comparability between entities would probably be lost.

2.20 The G4+1, accepting that it is difficult to find a robust distinction capable of universal application between 'operating activities' and 'other gains and losses', therefore proposes that standard-setters should specify the contents of the 'other gains and losses' category. This would be achieved by specifying in accounting standards those gains and losses that could be reported as 'other gains and losses'. In addition, accounting standards would also prescribe some (or all) of the contents of

'financing and other treasury activities' (possibly through the financial instruments project). The default category would be 'operating (trading) activities', ie if an item were not permitted to be included in 'other gains or losses' or 'financing and other treasury activities', then it must be included in 'operating (trading) activities'.

2.21 For some notable exceptions, such as property investment entities, it may be appropriate to report as part of operating activities, gains and losses that other companies would report as 'other gains and losses'. It is suggested, therefore, that where entities are actively managing aspects of their activities that would normally be reported in 'other gains and losses', it would be preferable to report these gains and losses as part of operating activities or financing activities, despite a requirement classifying them as items that would normally be reported as 'other gains and losses'. For specific industries, a requirement might be specified where there exists the ability to regulate separately (for example, where financial institutions are governed by a separate accounting standard).

2.22 Where entities choose to recognise in operating activities items that would otherwise be included in 'other gains and losses', it would seem appropriate to require such items to be separately disclosed, together with the reasons for regarding them as part of operating activities, and for the presentation to be applied consistently from one reporting period to the next. These conditions would provide the information necessary for a degree of comparability to be achieved and to prevent entities from classifying gains and losses as part of operations without adequate disclosure.

2.23 There may be items, however, that standard-setters decide should *always* be shown in 'other gains and losses' and accounting standards may not permit an option of showing them in operating activities.

Conclusion

2.24 The G4+1 proposes that a new standard on reporting financial performance should require all items of financial performance to be reported in a single statement of financial performance and classified in one of the following three components of the statement:

(a) operating (trading) activities;

(b) financing and other treasury activities; and

(c) other gains and losses.

The standard would specify the general characteristics of each component, on the basis of the matrix given in paragraph 2.12. Standard-setters will use these characteristics as the basis for determining how items will be allocated to the different components.

2.25 It is recognised that there are certain practical difficulties and additional conceptual matters to be addressed in implementing this approach, which would need to be considered by standard-setters on a case-by-case basis. In particular, the financial instruments project is likely to determine the reporting of items in the 'financing and other treasury activities' component of the statement of financial performance.

2.26 Chapter 3 examines these difficulties in terms of two particular items, and indicates the approach that standard-setters might take to reporting gains and losses arising on those items.

Chapter 3 The contents of 'other gains and losses'

3.1 In the international debate on a single statement of financial performance, only a few items have been identified as possible candidates for the third component, 'other gains and losses'. These are:

- foreign currency translation adjustments
- revaluation and disposal gains and losses on fixed assets
- actuarial gains and losses relating to pensions.

3.2 Of these, the present treatment of the first two is widely understood, and is discussed below in the context of a single statement of financial performance. The last is being debated at both national and international levels and this Paper does not seek to pre-empt that work (particularly as the debates are developing at different paces in different jurisdictions).

Foreign currency translation adjustments

3.3 In most countries, foreign currency translation adjustments arising on the net investment in a self-sustaining or independent foreign operation or entity are shown as a movement in equity (reserves), rather than as part of income. Conversely, translation gains and losses arising from integrated foreign operations are taken to the income statement. In countries requiring or allowing a second performance statement or a statement of comprehensive income, translation adjustments to the net investments are shown as items of financial performance, but outside the income statement. This treatment reflects the view that these adjustments have no impact on the foreign currency cash flows generated by the foreign entity that may be reinvested or distributed to the parent. Rather, they reflect economic effects of changes in exchange rates.

3.4 Foreign currency translation adjustments are holding gains and losses in the sense that they are caused by the effect of changes in prices (foreign currency exchange rates). They arise equally on assets and liabilities that are held for the long term and on current assets and liabilities. However, as viewed within the functional currency perspective of the US FAS 52 'Foreign Currency Translation' and similar standards, they are by their nature unrelated to the financial performance of operations. For example, a change in the carrying amount in a German parent's consolidated financial statements of a US$ receivable held by a US subsidiary arising from changes in the DM/US$ exchange rate is unrelated to the operating performance of the US subsidiary. Accordingly, it should not be reported as part of operating activities, but within 'other gains and losses' because it demonstrates the characteristics listed on the right-hand side of the matrix in paragraph 2.12, ie it is non-operating and caused by external price changes.

3.5 It follows that any foreign exchange gains or losses on disposal of the foreign operation would also be reported in the 'other gains and losses' section of the statement of financial performance. Such gains and losses are also in the nature of holding gains or losses: the disposal of the foreign entity does not change their nature.

Fixed/long-term assets

3.6 In the case of fixed or long-term assets, different jurisdictions tend to have different rules, not only on how gains and losses are reported, but also on *which* gains and losses can be recognised. The following analysis therefore indicates how all gains and losses arising on fixed assets might be reported, based on the matrix in paragraph 2.12, both for a regime where fixed assets cannot be revalued (ie using historical cost only) and for one in which the revaluation of fixed assets is permitted but not necessarily required. In both cases, tests for impairment are required where there are indications that an impairment has taken place. Different jurisdictions would need to assess the detail of how this approach would be applied to the individual

circumstances of their own model and rules. In addition, this approach does *not* encompass those assets, such as investment properties, for which no depreciation is charged and for which all gains and losses arising would be reported in the same component of the performance statement.

Assets held at historical cost

3.7 Perhaps the most obvious example of a gain that might be reported within 'other gains and losses' under the distinction discussed in Chapter 2 is a holding gain arising on the sale or other disposal of a tangible fixed asset such as the head office property of a manufacturer (losses and impairments are dealt with in paragraphs 3.10 and 3.11). Reporting that gain separately ensures that the operating result is not obscured by a realisation reflecting a change in market prices that has little link with the entity's routine manufacturing activities.

3.8 On the other hand, it is generally accepted that some of the change in the carrying amounts of fixed assets should be reported as part of operations, particularly a charge for depreciation, because it aims to reflect the extent to which fixed assets are consumed by the business. This expense arises from factors such as use, physical deterioration of the assets and obsolescence and is not therefore a holding loss.

3.9 Entities are expected to institute appropriate depreciation policies in accounting for their fixed assets. There may be cases, however, where the depreciation policy applied to an asset has not reflected the consumption of economic benefit by the entity and consequently a gain or loss on disposal arises. This, too, is not a holding gain or loss. It is, in effect, no more than an adjustment to the depreciation previously charged and, accordingly, is recognised within the 'operating/trading' section. Two such circumstances are likely to arise. First, there will be

marginal adjustments to depreciation, usually arising because depreciation rates are applied in a blanket fashion over a whole class of assets and thus discrepancies on the disposal of individual assets are likely to arise.* Second, there may be situations where with hindsight it can be seen that the pattern of depreciation has been misjudged entirely because the useful life of the asset has not been assessed correctly. In the second circumstance, if evidence could be produced that depreciation should have been charged over a different useful life, any excess or shortfall of depreciation should be added or charged to operations and the remainder, subject to any impairment charge (see below), taken to other gains and losses.

3.10 Impairment is a further factor to consider in the reporting of gains and losses arising on fixed assets. Impairment of an asset represents accelerated depreciation, and may result from factors such as technological obsolescence or from physical wear and tear. No impairment is recognised unless the carrying amount of an asset is above its recoverable amount. This Paper does not address the issue of the appropriate basis of measurement of an impaired asset. It merely seeks to indicate how losses should be reported when it is clear that the carrying value of an asset will not be recovered. In these circumstances the whole of the impairment loss should be reported in operations, along with depreciation.

3.11 Losses on disposal would be treated in the same way as impairment losses to the extent that they represent an impairment. To the extent that no impairment has taken place, however, such losses represent holding losses and should be reported in 'other gains and losses'. In those jurisdictions where impairments are assessed entirely in relation to fair values or market values, a loss resulting from a sale at market value is by definition an impairment and would be reported entirely under 'operating/trading'. In jurisdictions where a 'value to the

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* *It follows that adjustments of this nature are likely to arise on those assets consumed and disposed of by an entity on a regular basis, for example computers, cars and so forth.*

business' model* is adopted, a loss resulting from a sale at market value would not constitute an impairment to the extent that value in use exceeded market value. This reflects the fact that part of the loss would not have occurred if the asset had been retained by the business. Such a loss is not part of the cost of operations for the period but rather an incidental loss of value which has been crystallised by the decision to dispose of the asset. It is therefore more appropriately reported in 'other gains and losses'.

3.12 The following summarises the suggested reporting of depreciation, disposal gains and impairment and disposal losses on fixed assets in a single statement of financial performance *under a historical cost system.*

(a) Depreciation would be reported as part of 'operating/trading'. This represents the fundamental objective of recognising depreciation, ie to reflect in operations the cost of using the assets—the amount consumed—to generate the revenue of the period.

(b) An impairment loss on a fixed asset would be reported in 'operating/trading', as would a loss on disposal of the asset that represented an impairment. Disposal losses not representing an impairment would be reported in 'other gains and losses' (depending on the model used).

(c) Gains on disposal not representing depreciation adjustments would be recognised in 'other gains and losses'.

* *The 'value to the business' model is used in IASC and UK standards as a method of determining the current value of an asset. The value to the business of an asset is the lower of its replacement cost and its recoverable amount, where recoverable amount is the higher of value in use and net realisable value.*

Revalued assets

3.13 Present practice in those countries where revaluations of tangible fixed assets are permitted draws a distinction between gains and losses on fixed assets that are the result of revaluations, which are generally reported either in a second performance statement or as a movement in equity (a reserve), and gains and losses that arise on disposal, which are reported in the income statement. However, the essential nature of the gain or loss seems not to differ between these two cases, it is simply that the timing and certainty of the recognition of the gains or losses is different. In short, revaluations simply recognise gains or losses piecemeal over time until final disposal.[*] It is therefore proposed that, in a system that permits revaluations, gains and losses arising on the revaluation or disposal of fixed assets should be reported in the 'other gains and losses' section of the single performance statement (unless losses are caused by impairments: see paragraph 3.15).[†]

3.14 Depreciation on revalued assets would continue to be charged on the revalued amount and reported in 'operating/trading'. For assets that have previously been revalued upwards the depreciation charge is higher than it would be under historical cost in recognition of the higher current cost of the asset that has been used up.

3.15 As with depreciation, for a revalued asset an impairment loss will be higher if the asset has been subject to an upward revaluation as the loss will reflect the higher current cost of the asset that has been consumed. As with historical cost, under a 'value to the business' model, any further downward revaluation not constituting an impairment (ie to a fair value or market value that is below value in use) would be reported in 'other gains and losses'. In these situations, the existence of any 'indicators of

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* *Certainty is discussed in more detail in Chapter 4 on recycling.*

† *Where assets are revalued on a regular basis, material disposal gains and losses are likely to be rare.*

impairment'* —in this case a fall in fair value or market value—would trigger a test for impairment, so ensuring that the losses were reported correctly and that no impairment loss was reported in 'other gains and losses' in error. For example, in the case of a retail organisation that has a policy of revaluing its stores to market value, if the market value of a store falls but the value in use is higher than market value (but lower than the existing carrying value), then only the loss from carrying value to value in use would be reported in 'operating/trading'; the remaining loss does not represent an impairment and should be reported in 'other gains and losses'. In those jurisdictions where value in use does not form part of the basis for measuring impaired assets, write-downs to depreciated historical cost are treated as downward revaluations not involving impairment (and so would be reported in 'other gains and losses'); any further write-down would be treated as an impairment and reported in 'operating/trading'.

3.16 The same approach is taken to losses on disposal. In a 'value to the business' model, to the extent that the loss represents an impairment it would be charged to operations. Any remaining loss would be reported in 'other gains and losses'. A calculation would be necessary both to demonstrate that value in use was higher than the disposal proceeds and to quantify that part of the loss that should be reported in 'other gains and losses'.

3.17 The following summarises the suggested reporting of depreciation, revaluation and impairment of fixed assets in a single statement of financial performance in a system *where revaluation of fixed assets is permitted* (for assets still held at historical cost, the treatment would be as given in paragraph 3.12).

(a) Depreciation would be reported as part of 'operating/trading'. Where an asset has been revalued, the current period's depreciation charge would be based on the revalued amount. This provides consistency between the performance statement and the balance sheet and reflects the cost at current prices of using the asset during the period.

* *As noted in IAS 36, paragraph 9 and FRS 11, paragraph 10.*

(b) An impairment loss on a fixed asset would be recognised in 'operating/trading'.*

(i) In jurisdictions where impairment is determined on the basis of value to the business, other downward revaluations that are recognised would be reported in 'other gains and losses', ie to the extent that the revalued amount (market value) is lower than the written-down amount reflecting the impairment.

(ii) In jurisdictions where impairment is assessed in relation to fair value or market value, any loss that reduced carrying amount to depreciated historical cost would be treated as a downward revaluation and any further loss as an impairment.

(c) Revaluation gains should be recognised in 'other gains and losses'.

(d) A realised gain on a fixed asset reflects the same economic event, ie a rise in value, as an unrealised gain, albeit that a realised gain is confirmed by a transaction. Consequently, realised and unrealised gains and losses should be treated in the same way (as described in paragraph 3.13). As noted above, however, gains and losses on disposal that are in effect no more than adjustments to depreciation previously charged, usually on assets replaced regularly, should be reported within the 'operating/trading' section. Disposal losses would lead to an impairment test and would be reported as described in (b), ie the treatment would depend on the model used for assessing impairment.

* *The reversal of an impairment loss (in contrast to a revaluation gain) would also be recognised in 'operating/trading'.*

3.18 One example of how this approach to reporting gains and losses on fixed assets under the 'value to the business' model is demonstrated by recent UK standards on impairment (FRS 11) and the measurement of fixed assets (FRS 15). It was recognised in the UK that 'revaluation losses' may be due in part to a general fall in prices and in part to a consumption of economic benefits and that it is not always possible to determine which has caused a fall in value. The solution proposed by the first of these standards was to assume that any fall in value from the asset's previous carrying amount to depreciated historical cost would usually be due to a general fall in prices (which would be recognised in the UK's current second performance statement) and any fall in value from depreciated historical cost to the revalued amount would usually be due to a consumption of economic benefit (and hence recognised in the income statement or profit and loss account). Some commentators believe that the arbitrary cut-off line at the point of depreciated historical cost has some attractions in that it tends to enhance comparability between those companies that revalue fixed assets and those that do not. Some also believe that the approach has the advantage of simplicity of application. This is the approach that tends to be adopted in those jurisdictions where impairment is assessed by reference only to fair values and not value in use and where revaluations are permitted.

3.19 The approach would have disadvantages, however, in the context of a single performance statement, because under it gains and losses are reported on the basis of historical cost realisation, rather than on the basis of the characteristics of the gains and losses themselves (as summarised in the matrix in paragraph 2.12). The solution offered in FRS 11 was seen in the UK as a pragmatic response to the lack of a framework for reporting gains and losses with different characteristics. FRS 15 developed a more conceptual approach by stating that losses below depreciated historical cost should be reported in the profit and loss account (ie 'operating/trading') unless it can be demonstrated that the recoverable amount of the asset is greater than its revalued amount, in which case the loss (ie the extent to which the recoverable amount is greater than the revalued amount) should be reported in the statement of total recognised gains and losses (ie in 'other gains and losses').

Conclusion

3.20 This chapter has provided two illustrations of how standard-setters might allocate items of financial performance to different components of a statement of financial performance, using the criteria for allocation outlined in Chapter 2. The reporting issues surrounding these and other items of financial performance are, or will be, addressed on a standard-by-standard basis in most jurisdictions. Such standards would also usually deal with recognition and measurement issues.

3.21 The approach demonstrated here could help to bridge differences between standard-setters. For example, in the case of fixed or long-term assets, changes in value that are in the nature of holding gains or losses will be shown in 'other gains and losses', whether they arise on disposal only (for jurisdictions that do not allow revaluation of fixed assets) or on revaluation and disposal (for those jurisdictions that do). Gains and losses with similar characteristics are thus reported together, aiding comparability of financial performance across different entities and jurisdictions.

Chapter 4 Recycling

4.1 Recycling is an issue in the context of a single performance statement as much as it is in the context of two performance statements. Recycling is generally defined as the reporting of an item of financial performance in more than one accounting period because the nature of the item is deemed to have changed in some way over time. It raises the question of whether gains and losses originally reported in one component of the statement of financial performance should be reported again in another component at a later date.

Current practice

4.2 The UK standard-setter takes the view that gains or losses are reported only once, in the period in which they arise. Accordingly, present UK practice is that once a gain or loss has been recognised in the second statement, it should not be recognised in the first statement in a subsequent period simply because the amount has been realised. For example, under present practice, when a revalued fixed asset is sold, the profit or loss on disposal must be calculated by reference to the revalued amount. This means that the previous revaluation gain (or loss) is recognised once in the second statement but not again in a subsequent period in the first statement.

4.3 The UK approach is consistent in this respect with the treatment of revalued fixed assets by IASC, Australia and New Zealand. However, a different treatment of recycling exchange gains and losses on overseas net investments to the income statement on disposal of the foreign operation is required by IAS 21 (revised 1993) 'The Effects of Changes in Foreign Exchange Rates', FAS 52 'Foreign Currency Translation' in the USA, and CICA 1625 in Canada (Australian, New Zealand and UK standards prohibit such recycling). There are therefore conflicting rules internationally on whether recycling is an appropriate method of reporting aspects of financial performance.

4.4 It is worth noting, however, that the FASB made the following comments on recycling in this context in FAS 52 'Foreign Currency Translation' in the basis for conclusions section.

> "Pending completion of its project on reporting comprehensive income, however, the Board decided to include the accumulated translation adjustments in net income as part of the net gain or loss from sale or complete or substantially complete liquidation of the related investment. Sale or complete or substantially complete liquidation were selected because those events generally cause a related gain or loss on the net investment to be recognised in net income at that time. That procedure recognises the 'unrealised' translation adjustment as a component of net income when it becomes 'realised'. Although the information is probably marginal, the Board believes that this disposition is desirable until the concepts of reporting all components of comprehensive income are further developed. This disposition also can be considered to be in line with the existing view that nonowner transactions or events that change equity should be recognised in net income at some point."
>
> (paragraph 119)

Alternative views of recycling

4.5 The way that the question of recycling is viewed is strongly related to the view taken to financial reporting as a whole. There seem to be two general views.

(a) The 'other gains and losses' section of a single statement (or indeed a second performance statement) is a type of 'holding tank' for certain items pending the occurrence of a specific event that changes them in some way, when they will be reported again, as part of operating activities or financing activities.

(b) Each item of financial performance is reported once, when recognised, within the appropriate component of the statement of financial performance.

The 'holding tank' approach

4.6 There seem to be three main arguments (sometimes used in combination) as to why recycling (generally between 'other gains and losses' and operating activities or financing activities) should take place:

(a) when unrealised items become realised;

(b) when uncertain items become certain; or

(c) on some triggering event, on the grounds that all items should be shown in operating activities or financing activities as appropriate at some point.

The general effect of this approach is to emphasise a bottom line 'earnings' figure, through which all items of financial performance must pass at some point in time. The following paragraphs expand the three 'holding tank' arguments.

Realisation

4.7 There is a long-standing convention that realised profits should be recognised within the income statement. Such an approach leaves a second performance statement (or, in a single performance statement, the component 'other gains and losses') to report unrealised items, which are otherwise shown only as part of movements in shareholders' funds. If this were the basis for distinguishing items to be reported in the income statement and a second performance statement, then 'recycling' would need to take place between the two statements as unrealised items became realised. There would also need to be separate totals for realised and unrealised items in equity (reserves). This is the approach adopted in the USA, but not in the UK.

Uncertainty

4.8 Some regard recycling as an attractive concept because of a concern that the measurement of changes in value is uncertain. With this approach, the desire for or acceptance of immediate recognition in a second statement (or in 'other gains and losses') is based on the view that 'other gains and losses' should be used as a mechanism to cope with the uncertainty surrounding the measurement of a gain or loss. From this point of view, recycling the gains and losses into operating activities in subsequent periods follows as subsequent valuations either confirm or change the estimated amounts of the gains and losses.

The dominance of 'net income'

4.9 The last sentence of paragraph 119 of FAS 52 'Foreign Currency Translation' quoted in paragraph 4.4 indicates that the desire to recycle items into 'net income' or 'earnings' may not be based entirely on the concept of realisation and/or certainty. There are some who feel, if only on an intuitive basis, that all items of financial performance should appear in operating activities at some point because all items are ultimately part of operations.

The components approach

4.10 The approach to a single statement of financial performance advocated in this Paper envisages that the characteristics of the items allocated to the different components of financial performance are permanent, for the reasons discussed in Chapters 2 and 3. As explained in those chapters, the essence of the approach advocated in this Paper is to bring into a single statement of financial performance all recognised gains and losses, including those that were formerly taken directly to equity (reserves). The conventional wisdom expressed in FAS 52, that 'nonowner transactions or events that change equity should be recognised in net income at some point', needs to be reassessed in the context of this broader view of a statement of financial performance. Moreover, the components of the performance

statement, designed to assist users by classifying together items that have a similar effect on the entity, would be seriously obscured if they had superimposed on them a system of transfers reflecting a quite different realised/unrealised or certain/uncertain distinction.

4.11 The following paragraphs consider the various 'holding tank' arguments in the context of a components approach.

Realisation

4.12 Realisation may be the critical event in the traditional operating cycle of purchasing, manufacturing, distribution and sale. In the context of many financial exposures today that are affected directly or indirectly by the presence of deep and active markets, the realisation of an item provides information that is of limited value. A realised gain will reflect the same economic event as an unrealised gain; realisation merely represents confirmation of the gain. For example, where a portfolio of marketable securities is held, unrealised gains and losses may be realised virtually instantaneously and the relevant security repurchased at the same price for which it was sold.

4.13 Recycling based on realisation is not consistent with the approach outlined in Chapters 1-3. The allocation of items to different components is not based on realisation, but on the *nature* of the item (using the matrix in paragraph 2.12). The components of the proposed statement of financial performance do *not* represent stages of recognition through which any item would move over time. The approach advocated in this Paper seeks to classify items of financial performance on the basis of characteristics that are more useful than realisation and these characteristics in general do not change over time. For example, in the case of a gain on the revaluation or disposal of a fixed asset, the nature of the gain is always a holding gain; the mere realisation of the gain does not change its characteristics to the extent that it warrants a further inclusion in operating activities. The effect of realisation is better explained in the cash flow statement.

Uncertainty

4.14 The view that recycling is required because of uncertainty is an extension of the realisation argument, where realisation is seen as the mechanism through which the uncertainties arising from the use of accruals accounting (rather than cash accounting) are dealt with. As outlined above, the progression of an item from uncertainty towards certainty of measurement does not change its nature. If measurement is sufficiently certain for recognition of the gain or loss to be possible, then it is the nature of the item itself that should determine how it is classified in a statement of financial performance.

The dominance of 'net income'

4.15 The notion that all items of financial performance should eventually appear as part of operating activities conflicts with the premise that items of financial performance may have different characteristics and that it is appropriate to classify them according to those characteristics in a statement of financial performance. With the matrix in Chapter 2, an item would be reported under 'operating (trading) activities' (or possibly 'financing and other treasury activities') only if its overriding characteristics lay on the left-hand side of the matrix. Under this approach there is no conceptual basis for delaying recognition in operations (or financing/treasury where appropriate). In fact, the apparent desire on the part of some to do so seems to arise from concern about the combination of the volatility and size of such items, rather than their nature. However, if an item of financial performance is truly volatile, this should not be disguised in the statement of financial performance, regardless of the size of the item.

Conclusion

4.16 On the basis of the above analysis, the G4+1 believes that there is no conceptual justification for recycling and that consequently it should be prohibited. It is recognised, however, that recycling may be permitted or required by standard-setters in certain situations, in the short term, where this represents an improvement upon existing practice. As a general principle, once an item has been recognised in a statement of financial performance, it should not be recognised again in a future period in a different component. This enforces the principle that once items of financial performance can be reliably measured, they should be recognised in the appropriate component of financial performance.

SECTION 2: OTHER ISSUES

Chapter 5 Unusual items

5.1 Most members of the G4+1 require extraordinary items to be shown as a separate category in the income statement (see Appendix B for a summary of the relevant standards). Extraordinary items are characterised by a combination of infrequency of occurrence, atypical business activity and being outside management's control. They are reported after operating profit after tax and so are shown net of tax (with, usually, note disclosure of the related tax effects). In some jurisdictions the definition of extraordinary items has to be interpreted in the light of the definition of ordinary activities or operations. In the UK ordinary activities have been defined so widely that extraordinary items are in effect prohibited. Extraordinary items are also virtually prohibited by IASC and in Australia, Canada and New Zealand because strict criteria must be met in order to classify an item as extraordinary.

5.2 Most jurisdictions also require the separate disclosure of 'exceptional' items that fall within ordinary activities. 'Exceptional' items are also referred to as 'abnormal' or 'unusual' items. Such items are usually shown above the operating profit line (and before tax) and may be shown either on the face of the income statement or in a note.

Extraordinary items

5.3 The question arises whether the concept of extraordinary items is necessary or desirable under the approach advocated in this paper. The matrix in Chapter 2 that is used to determine the component of the statement of financial performance in which an item should be reported is partly based on characteristics similar to those that determine whether an item is classified as extraordinary. For example, in the USA extraordinary items are items that are of an unusual nature and

will not occur frequently. It would not be surprising if such items were also not part of operating activities. This means that some items currently reported as extraordinary would fall into the 'other gains and losses' component of a statement of financial performance.

5.4 If an item that is highly unusual belongs in operating activities there is no reason for reporting it in a separate component of the statement of financial performance solely on the grounds that it is highly unusual. To do so could result in similar items being presented differently by different entities and would override the basic premise of outlining the characteristics of the different components of financial performance and allocating items on that basis alone.

Conclusion

5.5 The G4+1 proposes that items that may be classified as extraordinary at present should in future be included in the appropriate component of the statement of financial performance, with separate disclosure being permitted. This means that extraordinary items would cease to exist as a separate category.

Unusual/abnormal/exceptional items

5.6 Although the G4+1 believes that it is not appropriate to treat extraordinary items as a separate category, some consideration must be given to the treatment of items reported within, say, operating activities that require separate disclosure in order that users of the statement of financial performance can better understand the entity's reported performance. Such items would include not just those previously regarded as extraordinary but also items that might at present be disclosed as exceptional, unusual or abnormal.

5.7 Two issues arise:

(a) whether it is appropriate to show such items separately on the face of the statement of financial performance; and if so,

(b) whether it is appropriate to report such items in a separate line called 'exceptional items' rather than with the line item in which they would normally be included.

5.8 Information on items that are unlikely to happen on such a scale again, or unlikely to occur again at all, is clearly useful to users and assists them in their assessment of possible future results. It would also be difficult, if not impossible, to prohibit disclosure of additional information of this sort on the face of the statement of financial performance.

5.9 However, grouping such items together in a separate 'exceptional items' line implies that exceptional items have more in common with each other than with the line item to which they relate. Given the wide variety of exceptional items that could arise, this is unlikely. A separate 'exceptional items' line also gives the user no information about the nature of the items being reported and may lead to undue significance being attributed to 'pre-exceptional' results.

Conclusion

5.10 The G4+1 proposes that entities should be permitted to disclose exceptional items on the face of the performance statement, but that these should be disclosed next to the line item to which they relate, regardless of the component of the statement of financial performance in which that line item falls, rather than aggregated under one heading of 'exceptional items'. For example, if an entity undertakes an internal restructuring that is regarded as exceptional, it should include the related costs (such as redundancy costs) in, say, the line item 'administrative expenses' within the 'operating (trading) activities' component. Any related financing costs, however, should be shown with the relevant line item in the 'financing and other treasury activities' component of the statement of financial performance.

5.11 A further proposed requirement is that, where an entity emphasises profit on a 'pre-exceptional' basis, it should provide in a note to the statement of financial performance a summary of performance over a reasonable period of time (perhaps five years), for the purposes of comparison and examination of trends. Where such a summary is provided, it should be structured to show pre-exceptional results, exceptional items and post-exceptional results.

Chapter 6 Continuing activities, discontinued/discontinuing activities and acquisitions

Continuing and discontinued/discontinuing activities

6.1 IASC, Canada, New Zealand, the UK and the USA require the results of discontinued/discontinuing operations to be shown separately from continuing activities. Australia is proposing to introduce requirements similar to those of IASC. A summary of the requirements and proposals is given in Appendix C.

6.2 Distinguishing between discontinued/discontinuing activities on the one hand and continuing activities on the other is useful because it presents clearly the effect of management's decisions to terminate or dispose of parts of the business and also provides a basis for assessing the future performance of the continuing activities.

6.3 There are, however, differences between the definitions of discontinued/discontinuing activities in IASC, Canadian, New Zealand, UK and US standards: the most significant is that New Zealand and the UK require a discontinuation to be completed by (or just after) the year-end, while IASC, Canada and the USA merely require the discontinuation to be planned. The emphasis is placed on discontinu*ing* activities by IASC, Canada and the USA, as opposed to discontinu*ed* activities by New Zealand and the UK.

6.4 The advantage of the IASC/Canadian/US approach is that the disclosure of a discontinuing activity is made as soon as management has made its plan—the disclosure reflects the economic decision-making process of management and gives timely information to users of the financial statements.

6.5 The advantage of the New Zealand/UK approach is that it removes the potential for management in extreme circumstances to manipulate the reporting of results of continuing activities by identifying activities as 'discontinued' in a loss-making period, then retaining the activities and including them again in 'continuing operations' when the loss-making period is over. Under the New Zealand/UK approach, an entity may disclose details of activities it intends to discontinue in the notes to the financial report.

Conclusion

6.6 Whatever the precise definition of discontinued/discontinuing activities, it is generally accepted that information of this sort is of value to users of financial statements, mainly because it strengthens the predictive value of the income figures. This information remains useful in the approach set out in this Paper of allocating items to different financial components. The G4+1 proposes that each component of a statement of financial performance should distinguish between continuing and discontinuing/discontinued activities.

6.7 One problem that may arise from the separate disclosure of continuing and discontinuing/discontinued activities in each component is that the face of the statement may become cluttered and difficult to read. For this reason it seems desirable to permit the analysis to be given in a note to the financial statements.

Acquisitions

6.8 The UK's FRS 3 'Reporting Financial Performance' defines acquisitions as 'operations of the reporting entity that are acquired in the period'. The post-acquisition results of acquisitions are required to be disclosed as a subcomponent of continuing activities, although the standard allows estimates to be made where post-acquisition results are difficult to obtain (ie where an acquisition has been merged quickly into existing operations some time before the end of the period) and it does not insist on disclosure where this is impracticable. Separate disclosure of the results of acquisitions is not required by any other member of the G4+1.

6.9 The disclosure of the results of acquisitions is arguably of benefit to users as it enables them to identify, at least to some extent, internally generated growth compared with growth through acquisition. FRS 3 also encourages disclosure in the notes of the following full-year results of an acquired entity.

Conclusion

6.10 The G4+1 proposes that the results of acquisitions made during the period should be disclosed, unless such disclosure is impracticable.

6.11 The following example shows how disclosure might be made within the 'operating (trading) activities' component.

Example - Discontinuing/continuing operations and acquisitions

	Continuing	*Discontinued*	*Total*
Revenues	600	175	775
Cost of sales	455	165	620
Excess of revenue over cost of sales	145	10	155
Net operating expenses			
Distribution costs	56	13	69
Administrative expenses	41	12	53
Other operating income	(8)	0	(8)
	89	25	114
Less prior period provision	0	(10)	(10)
	89	15	104
Operating income	56	(5)	51

The total figures for continuing operations include the following amounts relating to acquisitions: revenues 50,000, cost of sales 40,000 and net operating expenses 8,000 (namely distribution costs 7,000, administrative expenses 3,000, less other operating income of 2,000).

6.12 Similar disclosures could be made for items in 'financing and other treasury activities' and in 'other gains and losses'.

Chapter 7 Tax expense

7.1 There are a number of ways that tax expense could be presented in a statement of financial performance, ranging from reporting it as a single line at the foot of the statement through to allocating tax expense to each individual reported line. It is doubtful whether the latter level of detail would be helpful to users.

7.2 Reporting tax expense as a single line item at the foot of the statement of financial performance implies that tax expense is sufficiently different from all other types of revenues and expenses to justify its being reported alone. Although this approach might seem reasonable under a 'flow-through' approach to tax (where the tax for the year is regarded as being derived from the overall profit for the year rather than from individual transactions making up that profit), it is not consistent with a 'full provision' approach (where tax is assumed to arise from, and be allocable to, individual transactions).

7.3 Given a 'full provision' approach to recognising tax expense, the allocation of tax expense across components seems consistent with the predictive value approach underpinning component reporting. It seems useful, for example, for the tax expense associated with operating and financing items to be reported with those items and for the tax expense associated with other gains and losses to be reported with them.

7.4 However, in allocating tax expense, some degree of arbitrariness is unavoidable because of the difficulties illustrated by the following questions:

(a) Where the tax rate alters with the level of profits, which component or part of a component should be deemed to be at the margin or should an average rate be applied to all components?

(b) Where one component has a tax loss and another a taxable profit, which should get the benefit of the tax loss?

7.5 Further, although it may be agreed that tax expense should be allocated within a period to various components, the level of allocation is a separate issue. For example, a single amount might be allocated for tax expense to each component of performance that is reported. Alternatively, tax expense might be further allocated within components to various subcomponents.

7.6 In the USA, FAS 130 'Reporting Comprehensive Income' requires amounts to be shown for pre-tax income, income tax expense and post-tax income. Items of other comprehensive income can be shown either net of related tax effects or before related tax effects with one amount shown for the aggregate income tax expense or benefit related to the total of other comprehensive income items. The FASB debated whether items of other comprehensive income should be shown before or after their related tax effects. The issue was complicated by the traceability of 'reclassification adjustments' (recycling adjustments) and the way other comprehensive income items would be shown under the alternative presentation, as changes in equity (ie net of tax). In the light of these complications, the FASB allowed either treatment, provided sufficient disclosure was given so that users could identify pre- and post-tax amounts.

7.7 In the UK, UITF Abstract 19 considers where to report tax expense arising on the retranslation of foreign currency borrowings that finance or provide a hedge against an investment in a foreign entity. It concludes that where the gain or loss arising from the retranslation of such borrowings is reported in the statement of total recognised gains and losses (equivalent to the 'other gains and losses' section), any tax expense arising on the gain or loss should also be reported in that statement. In Australia, similar requirements are found in Accounting Standard AASB 1012 'Foreign Currency Translation'.

7.8 It seems therefore that allocation of tax expense between components is already practised despite some inevitable arbitrariness. Given this, the three most obvious choices for tax allocation seem to be:

(a) Allocate tax expense to three amounts, one for each component of the statement of financial performance.

(b) Allocate tax expense to two amounts: one for the total of the 'operating (trading) activities' and 'financing and other treasury activities' components; and the other for the 'other gains and losses' component—as shown in the example given in paragraph 2.7.

(c) Allocate a single tax expense figure to the total of the 'operating (trading) activities' and 'financing and other treasury activities' components and allocate tax to each item individually in the 'other gains and losses' component. This reflects the often unusual tax consequences of some of the items in the 'other gains and losses' component, such as those arising in respect of revaluations.

Conclusion

7.9 The G4+1 proposes that the approach under (b) above should be adopted. This would leave the statement of financial performance relatively uncluttered and without the possibly arbitrary effects of a more detailed allocation of tax expense. However, in order to provide further useful information a note of a breakdown of the tax effect of each item in 'other gains and losses', as shown below, should be required.

Example - Disclosure of tax effects of items in 'other gains and losses'

	Pre-tax amount	*Tax (expense) or benefit*	*Amount net of tax*
Gain on disposal of discontinued operation	3,000	(900)	2,100
Profit on sale of properties	6,000	(2,700)	3,300
Revaluations of long-term assets	4,000	(1,000)	3,000
Foreign currency translation adjustments	(2,000)	600	(1,400)
Other gains and losses	11,000	(4,000)	7,000

Chapter 8 Changes of accounting policy

8.1 There are two circumstances in which a change of accounting policy may be made:

(a) where a new accounting standard is introduced (or a legislative or regulatory change requires an accounting policy change); and

(b) where an entity makes a voluntary change of accounting policy.

The situation in (a) is not addressed in this Paper, because circumstances are likely to vary widely among different jurisdictions owing to local legal requirements, existing standards or conditions specific to new standards.

8.2 In the case of voluntary changes of accounting policy, two related concerns are:

(a) to restrict adjustments to actual changes of accounting policy as distinct from changes in estimates (see Chapter 9); and

(b) to ensure consistency between financial statements produced in different periods by allowing a change of policy only if it will give a more relevant presentation than the one it replaces.

8.3 It would be wrong to discourage entities from introducing changes of accounting policies where the change would lead to improved financial reporting. The G4+1 therefore proposes that voluntary changes of accounting policy should be permitted, as long as the new policy produces a more relevant presentation than the one it replaces. The initial adoption or alteration of an accounting policy necessitated by events or transactions that are occurring for the first time or were previously immaterial in their effect would not be regarded as a change of accounting policy.

Accounting treatment

8.4 There are three main approaches that might be considered for dealing with voluntary changes of accounting policy.

(a) *Prospective application*. The new accounting policy is applied only to events and transactions occurring after the date of the change. No cumulative catch-up adjustment is made.

(b) *Cumulative adjustment with no restatement of prior periods*. The new accounting policy is applied to events and transactions from the date of origin of such items and a cumulative adjustment reflecting the effect of the change in an accounting policy on prior periods is made in the period in which the change is made. The financial statements for prior periods are not restated. Alternative treatments of the cumulative adjustments are possible: recognition as an item in net income or as an adjustment of the opening balance of retained earnings.

(c) *Retrospective application with restatement of prior periods.* The new accounting policy is applied to events and transactions from the date of origin of such items. The financial statements for each prior period presented for comparative purposes are restated to reflect the new policy. The balance of retained earnings at the beginning of the earliest period presented is restated to reflect the cumulative effect of the change on periods before that date.

Conclusion

8.5 Prospective application or cumulative adjustment with no restatement of prior periods provides no comparability between items arising from events and transactions before and after the change in accounting policy and runs the risk of being misleading. Consequently, retrospective application is the approach preferred by the G4+1.

8.6 Some standard-setters have prohibited restatement of prior periods or offered an alternative of cumulative adjustment but with no restatement of prior periods because of concerns that retrospective application will be abused. In most cases, however, disclosure is required (sometimes on the face of the income statement) of the figures that would have been shown if restatement of prior periods had been required. If this information is thought to be so vital, it seems appropriate to make this (method (c) above) the required accounting treatment, reflecting the view that the new accounting policy is superior to that previously used. Restatement of prior periods would not be required in the (rare) circumstances where sufficient information was not available.

8.7 There is also a question of whether the cumulative effect is included in the statement of financial performance for the period or shown only as an adjustment to opening retained earnings. It is proposed that the adjustment should be shown as an adjustment to opening retained earnings, rather than in the performance statement, as it does not represent performance of the current period.

Chapter 9 Changes in estimates and corrections of errors

9.1 Many items in financial statements are estimates that may be amended based on information arising in later periods. Similarly, it may be discovered during the current accounting period that errors were included in the financial statements of the prior period. Changes in estimated amounts/corrections of errors can be recognised in financial statements in a number of ways:

(1) as an adjustment of the previous period's comparative figures with a prior period adjustment to opening retained earnings;

(2) by inclusion of the adjustment in the current period without separate disclosure; or

(3) by inclusion of the adjustment as a separate line item in the current period in the relevant component of the statement of financial performance.

9.2 The advantage of approach (1) is that the statement of financial performance for the current period is reported correctly, without any component relating to errors made in previous periods, and thereby gives users better predictive information. On the other hand, this treatment would be open to abuse as it might encourage entities consistently to underestimate losses. Approaches (2) and (3) result in the operating activities section showing the full operating gain or loss, albeit over more than one period. The approaches are illustrated by the following example.

Example

9.3 Suppose that the 1998 results of an entity show an estimate of an expense of 3 million. During 1999 it is discovered that the expense has been understated by 500,000. The 1999 financial statements, with comparatives for 1998, would appear as follows under the various alternative treatments.

Approach (1): restate the previous year's figures and show a prior period adjustment as a reduction in opening retained earnings for 1999 of 500,000, so *operating activities* appear for both years as if the error had been corrected in 1998.

	1999	*1998 (restated)*
Operating activities		
Sales	35,000	30,000
Cost of sales	(17,500)	(17,000)
Other expenses	(4,000)	(3,500)
Results from operating activities	13,500	9,500
Financing activities	X	X
Other gains and losses	X	X
Total gains and losses relating to the year	X	X

In addition, a loss of 500,000 would be shown as a prior year adjustment to opening retained earnings in the note showing the movement on reserves for the year.

Approach (2): recognise the 1998 understatement as part of operating activities for the current year.

	1999	*1998*
Operating activities		
Sales	35,000	30,000
Cost of sales	(17,500)	(17,000)
Other expenses	(4,500)	(3,000)
Results from operating activities	13,000	10,000

Approach (3): recognise the 1998 understatement as a separate line item in the current year's accounts under operating activities.

	1999	*1998*
Operating activities		
Sales	35,000	30,000
Cost of sales	(17,500)	(17,000)
Other expenses	(4,000)	(3,000)
Operating profit for the current year	13,500	10,000
Exceptional item: correction of error		
Understatement of 'other expenses' in 1998	(500)	—
Results from operating activities	13,000	10,000

Correction of errors vs changes in estimate

9.4 In some countries, a distinction is made between the correction of errors and changes in estimates. For example, guidance in the USA (APB 20) states that:

> "Errors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared. In contrast, a change in accounting estimate results from new information or subsequent developments and accordingly from better insight or improved judgement. Thus, an error is distinguishable from a change in estimate."

9.5 As demonstrated in Appendix E, the approach to changes in estimate is not controversial, and approach (2) is generally used. In the case of errors, however, there is a divergence in approaches. In most of the G4+1 constituencies, the treatment of the effect of correction of errors as prior period adjustments (approach (1)) is restricted to so-called 'fundamental errors'. These are usually defined as errors that destroy the fair presentation of the financial statements of the relevant prior periods or render those financial statements completely unreliable. The implication is that the financial statements in question would have been withdrawn and restated had the error been discovered before the new financial statements were due to be issued. Correction by restatement of the prior period figures (approach (1)) can be regarded as a proxy for withdrawing and reissuing the relevant prior period financial statements.

9.6 In some countries (in particular the USA) no distinction is made between errors of differing magnitude. The treatment of errors follows that of 'fundamental errors' in other countries (ie as prior period adjustments), but by implication *all* material errors should be treated in this way because accounting standards apply only to material items.

Conclusion

9.7 In relation to changes in estimate, it is appropriate to regard the previous periods' figures as 'correct' on the grounds that they were prepared on the basis of the best information available at the time. The change should be shown as part of the current period's financial performance because it derives from developments during this period (approach (2)). In general, there would be no need to show the change in estimate separately unless it was of such a size that it required separate disclosure as an abnormal or exceptional item. In any event, for the reasons given in Chapter 5 on exceptional items, the change in estimate should be shown within the line item to which it relates.

9.8 Immaterial errors that are discovered in subsequent periods would be treated in the same way as changes in estimate, as described in the previous paragraph. It may be found, however, that financial statements of prior periods have been issued containing errors that are of such materiality that, had they been discovered during the preparation of the financial statements, those statements would have been amended before issue. The G4+1 proposes that, where such material errors are discovered in subsequent periods, they should be recognised by amending prior periods presented, with an adjustment to the opening retained earnings of the earliest period presented.

APPENDIX A

Reporting financial performance: a summary of existing practice of G4+1 members (in chronological order of pronouncement)

UK

A1 The ASB was the first standard-setter to introduce the concept of total financial performance when, in 1992, FRS 3 'Reporting Financial Performance' introduced a statement of total recognised gains and losses (STRGL). This statement, designated a performance statement (like the income statement), shows the total gains and losses recognised (rather than realised, as is primarily the case in the income statement) during the period.

A2 FRS 3 says about the STRGL:

> "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."

A3 FRS 3 was based on principles laid out in a FASB Exposure Draft of 1981, which was not itself carried through into a standard. The two main items that are shown in the STRGL (as well as the retained profit or loss for the period) are those that were already required by accounting standards or by law to be taken directly to reserves, ie:

(a) revaluation gains and losses on tangible fixed assets; and

(b) foreign currency translation adjustments on net investments in self-sustaining foreign entities.

A4 It was thought to be particularly important that recognised gains and losses for both these items should be reported in a primary statement of financial performance, rather than being shown only as a movement on reserves, relegated to the notes to the accounts.

A5 FRS 3 began a move away from the emphasis on the realisation of profits in performance reporting. At the time, the conceptual basis for the allocation of items to the STRGL rather than to the profit and loss account (income statement) was not explicitly stated. As shown above, it was simply stated that the STRGL should show those gains or losses recognised during the period that were required by existing accounting standards or company law to be taken directly to reserves. The ASB took the view, however, that the reason why these items were reported in the STRGL was that they were in the nature of 'holding' gains and losses relating to items of a capital nature, and this was mentioned in the standard (see paragraph A2 above).

New Zealand

A6 The standard produced in 1994, FRS-2 'Presentation of Financial Reports', requires a statement of financial performance (showing a net surplus or deficit), which is the equivalent of an income statement as defined in other countries, and a statement of movements in equity (with disclosure of certain movements).

USA

A7 FAS 130 'Reporting Comprehensive Income' was published in 1997. It requires all items of performance recognised in the period to be reported, but allows 'other comprehensive income' (ie items that would be reported in the STRGL in the UK) to be shown in various ways, ie:

(a) as part of a single performance statement with net income;

(b) in a second performance statement; or

(c) as part of a statement of changes in equity, though with its own subtotal.

A8 Recycling adjustments (or 'reclassification adjustments') are required between 'other comprehensive income' and 'net income' to avoid double-counting within total comprehensive income of items in 'net income' that have previously been reported in 'other comprehensive income'.

IASC

A9 IAS 1 (revised 1997) 'Presentation of Financial Statements' introduced a requirement for a primary financial statement showing those gains and losses not presented in the income statement. This statement, however, may be presented either as a traditional equity reconciliation, or as a statement of

performance in its own right. Whichever approach is adopted, a total for the gains and losses arising from the entity's activities during the period must be provided. Only items that are required by other IASs to be recognised directly in equity may be included in the new statement. These include gains and losses on revaluation of properties and exchange differences on translation of the financial statements of foreign entities.

Canada

A10 Financial performance is normally reported in an income statement and a statement of retained earnings. The statement of retained earnings comprises the accumulated balance of income less losses arising from the operation of the business, after taking into account dividends, refundable taxes and other amounts that may properly be charged or credited thereto. Retained earnings do not include capital donations that are contributions by owners. Most entities present the income statement and statement of retained earnings as separate statements. However, some entities present the statement of retained earnings as a continuation of the income statement. Exchange gains and losses arising from the translation of the financial statements of a self-sustaining foreign operation are required to be included in a separate component of shareholders' equity.

Australia

A11 An Exposure Draft ED 93 'Statement of Financial Performance and Ancillary Amendments' was published in July 1998. It proposes the preparation of a single statement of financial performance that includes disclosure of 'non-owner changes in equity' (which are limited to asset revaluations and exchange differences relating to self-sustaining foreign operations) as a separate component of the statement. Recycling is prohibited.

APPENDIX B

Unusual items: a summary of existing practice by the G4+1 members

IASC

B1 In IAS 8 (revised 1993) 'Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies', extraordinary items and ordinary activities are defined as follows:

> "*Extraordinary items* are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and therefore are not expected to recur frequently or regularly.
>
> *Ordinary activities* are any activities which are undertaken by an enterprise as part of its business and such related activities in which the enterprise engages in furtherance of, incidental to, or arising from these activities."

Extraordinary items are disclosed separately after the profit and loss from ordinary activities.

B2 The standard does not define exceptional items, but it does state that, where items of income and expense within profit/loss from ordinary activities are of such a size, nature or incidence that their disclosure is relevant to explain the performance of the entity, the nature and amount of such items should be shown separately.

Australia

B3 ED 93 proposes the adoption of the IAS 8 definition of extraordinary items and ordinary activities (see above).

B4 Australia also intends to replace the present requirement to disclose abnormal items with a requirement to disclose revenues and expenses that are of such a size, nature or incidence that their disclosure is relevant to explain the performance of the entity.

Canada

B5 Section 3480 defines extraordinary items as:

> "items which result from transactions or events that have all of the following characteristics:
>
> (a) they are not expected to occur frequently over several years;
>
> (b) they do not typify the normal business activities of the entity; and
>
> (c) they do not depend primarily on decisions or determinations by management or owners."

B6 Extraordinary items, net of applicable income taxes, are required to be included in net income and reported separately. The Section also notes that income statement items resulting from events that have some but not all of the characteristics of extraordinary items, but result from transactions or events that are not expected to occur frequently over several years or do not typify normal business activities of the entity, would be included in the income statement and separately disclosed.

New Zealand

B7 FRS-7 requires separate disclosure of extraordinary items (net of tax) after operating surplus and disclosure of individual items either on the face of the performance statement or by note. Extraordinary items are defined as:

> "those items of revenue or expense which derive from events or transactions that:
>
> (a) are not expected to occur frequently; and
>
> (b) are distinct from the ordinary operations of the entity; and
>
> (c) are outside the control or influence of managers or owners."

B8 Although ordinary activities are not defined, the explanation makes it clear that the ordinary activities of an entity are not restricted to its trading activities but embrace all activities carried on by the entity to achieve its objectives. To be classed as extraordinary, a discontinued operation would have to meet all three criteria, including that the discontinuation was outside the control of management, eg through nationalisation.

B9 FRS-2 requires a component of net surplus or deficit to be reported separately if separate disclosure is necessary in order to achieve the objectives of general purpose financial reporting. This might be done in various ways and the standard suggests consideration of materiality, amounts affected in different ways by different economic conditions, the nature of particular items and the necessary detail required. Guidance is also given on frequency of occurrence.

UK

B10 FRS 3 in effect outlawed extraordinary items through the following definitions of extraordinary items and ordinary activities:

> *"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."
>
> *"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."

Extraordinary items are included in the standard, however, as they represent a statutory format heading in UK companies legislation. Where given, they are to be shown net of their related tax after profit on ordinary activities after taxation.

B11 FRS 3 defines exceptional items as:

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

They are required to 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 and disclosed by way of a note. They can, however, be shown on the face of the profit and loss account if necessary to give a true and fair view. FRS 3 also requires certain items to be shown on the face of the profit and loss account after operating profit and before interest (the so-called 'paragraph 20 exceptionals'):

(a) Profits/losses on the sale or termination of an operation

(b) Costs of a fundamental reorganisation or restructuring

(c) Profits or losses on the disposal of fixed assets.

USA

B12 APB 30 defines extraordinary items as items that are *both* unusual in nature and infrequent in occurrence. They are required to be shown separately after the results of continuing operations.

B13 Unusual or infrequent items (ie items that meet one but not both of the criteria of extraordinary items) are required to be classified and reported separately but within continuing operations. Disclosure can be on the face of the income statement or as a note.

APPENDIX C

Discontinued/discontinuing and continuing operations

The definition of discontinued/discontinuing items

IASC

C1 Under IAS 35 a discontinuing operation is a component of an entity:

"(a) that the entity, pursuant to a single plan, is:

(i) disposing of substantially in its entirety, such as by selling the component in a single transaction, by demerger or spin-off of ownership of the component to the entity's shareholders;

(ii) disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually; or

(iii) terminating through abandonment;

(b) that represents a separate major line of business or geographical area of operations; and

(c) that can be distinguished operationally and for financial reporting purposes."

Australia

C2 ED 95 'Discontinuing Operations', released in October 1998, proposes similar requirements to those in IAS 35.

Canada

C3 Section 3475 defines discontinued operations as "the operations of a business segment that has been sold, abandoned, shut down, or otherwise disposed of, or that is the subject of a formal plan of disposal".

New Zealand

C4 FRS-9 defines discontinued activities as "the activities of a business segment that have been sold or terminated".

UK

C5 Under FRS 3, discontinued operations are operations of the reporting entity that are sold or terminated and 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.

USA

C6 APB 30 defines discontinued operations as:

> "The operations of a segment of a business that has been sold, abandoned, spun off, or otherwise disposed of or, although still operating, is the subject of a formal plan for disposal."

The results of discontinued operations are disclosed separately from the 'measurement date of a disposal' (effectively the date of a degree of commitment to the discontinuation by management) up to the period in which the 'disposal date' (the date of closing the sale or the date operations cease) occurs.

Disclosures

IASC

C7 The IAS 35 disclosures are broken down into initial and updating disclosures, where the event that triggers initial disclosure is the occurrence of *either* of the following, whichever occurs earlier:

(a) the board entering into a binding sale agreement for substantially all the assets of the discontinuing operation; *or*

(b) the approval by the board of a formal plan for discontinuance *and* announcement of that plan by the entity.

Both initial and updating disclosure events will also be reflected in the financial statements if the events occur in the post balance sheet period.

C8 The initial disclosures include the amounts of revenues, expenses, and pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial period and the income tax expense relating thereto.

C9 In addition, the initial disclosures under IAS 35 are not restricted to the income statement, but include all aspects of the results of the discontinuing operations, including assets, liabilities and cash flows. Achieved or expected selling prices and profits/losses on the sale of the net assets should be disclosed, along with various other details including the date the discontinuance was announced, the period in which it is expected to be completed (if known) and the (IAS 14) segments in which it was reported.

C10 IAS 35, under 'updating disclosures', requires entities to disclose any significant changes in the amount or timing of cash flows relating to the assets and liabilities to be disposed of or settled and the events causing those changes. Disclosure should be continued until the completion of the discontinuation, or until the entity withdraws from a previously reported plan.

C11 All these disclosures may be shown in the notes to the accounts under IAS 35. Only the pre-tax gain or loss recognised on the disposal of assets or settlement of liabilities attributable to the discontinued operation must be shown on the face of the income statement.

Australia

C12 ED 95 contains similar proposals to the disclosure requirements in IAS 35.

Canada

C13 The results of discontinued operations are included in net income and reported separately for the current and prior periods. The results of discontinued operations include the results of operations prior to the measurement date (the date on which management adopts a formal plan of disposal) as well as the net gain or loss from discontinued operations other than any extraordinary gain or loss. Income taxes applicable to the results of discontinued operations prior to the measurement date and to the net gain or loss from discontinued operations are separately disclosed. In addition, revenue for the reporting period applicable to discontinued operations is separately disclosed.

New Zealand

C14 FRS-9 requires the operating revenue and operating surplus or deficit from discontinued activities to be shown separately. In addition, where practical, the gain or loss on the sale of assets from the discontinued activities should be disclosed as a separate component of the results from discontinued activities to ensure that the ordinary trading activities that are discontinued are distinguished from the gain or loss on sale.

UK

C15 FRS 3 requires an analysis into continuing operations, acquisitions (as a component of continuing operations) and discontinued operations to be disclosed to the level of operating profit. The analysis of turnover and operating profit is the minimum disclosure required in this respect on the face of the profit and loss account.

USA

C16 APB 30 requires the results of continuing operations to be reported separately from discontinued operations. Operations of a segment that has been or will be discontinued must be reported separately as a component of income after income from continuing operations and before extraordinary items.

APPENDIX D

Changes of accounting policy: a summary of existing practice by G4+1 members

IASC

D1 The benchmark treatment under IAS 8 (revised 1993) is that a change in accounting policy is treated as a prior period adjustment with restatement of prior year results, ie they are 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.

D2 The allowed alternative is to take the cumulative change in retained earnings as a part of net income for the period.

Australia

D3 AASB 1001 'Accounting Policies' requires that adoption of a new standard should be dealt with according to the transitional provisions of the new standard. It also requires, in relation to other changes in accounting policy, the recognition of a revenue or expense in the statement of financial performance in the period in which the accounting policy is changed, if the amount is reasonably determinable. The comparative information is not restated, but similar information is required in the notes.

Canada

D4 Section 1506 requires that a new accounting policy should be applied retrospectively, unless the necessary financial data is not reasonably determinable, or the change is made to comply with new Handbook Recommendations, Accounting Guidelines, EIC Abstracts or legislative requirements that require or permit prospective application. Where retrospective application takes place, restatement of previous periods presented

is also required, where possible. If not possible, an adjustment should be made to the opening balance of retained earnings of the current period, or such earlier period as is appropriate, to reflect the cumulative change in prior periods.

D5 Section 1506 explains that neither (a) the initial adoption or alteration of an accounting policy necessitated by events or transactions that are clearly different in substance from those previously occurring, nor (b) the initial adoption of an accounting policy in recognition of events or transactions occurring for the first time or that previously were immaterial in their effect, is considered to be a change in an accounting policy.

New Zealand

D6 FRS-7 requires that the financial effect of all changes in accounting policy which impact on the measurement of financial performance should be recognised in the statement of financial performance in the period in which the decisions to change the policies are made and applied. This approach is adopted because of the difficulty of distinguishing between changes in accounting policy and changes in estimates. An adjustment against opening equity can be made only where this is required by a new standard or legislation. Comparatives (and historical summaries) can be restated by making a line adjustment.

UK

D7 Under FRS 3 a change in accounting policy is treated as a prior period adjustment with restatement of prior year results, ie they are 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 adjustment is also shown at the foot of the STRGL of the current period. The effect of the change in accounting policy on the results for the preceding period should be disclosed where practicable.

D8 Neither of the following would be regarded by FRS 3 as a change in accounting policy:

(a) The initial adoption or alteration of an accounting policy necessitated by events or transactions that are clearly different in substance from those previously occurring.

(b) The initial adoption of an accounting policy in recognition of events or transactions that are occurring for the first time or were previously immaterial in their effect.

D9 FRS 3 requires entities to distinguish carefully between changes in accounting policy and mere changes in estimate, the effects of which must be recognised in the reporting period of change (and future periods where necessary).

USA

D10 The general requirement is for prospective application only (ie previously reported comparatives are not restated). The cumulative effect on the amount of retained earnings brought forward is included in the net income for the period of the change. Disclosure is made of the effect on net income for the period. In addition, pro forma information must be given on the face of the income statement of the retrospective effect of the change to all prior periods affected.

APPENDIX E

Changes in estimates and corrections of errors: a summary of existing practice by G4+1 members

IASC

E1 In relation to *changes in estimates*, IAS 8 (revised 1993) requires that the effect is only recognised in the reporting period of the change if the change affects that period only, or in the period of the change and future periods if the change affects both.

E2 IAS 8 defines *fundamental errors* as:

> "Errors discovered in the current period that are of such significance that the financial statements of one or more prior periods can no longer be considered to have been reliable at the date of their issue."

E3 The IAS 8 benchmark treatment of fundamental errors requires an adjustment against the opening balance of retained profits and restatement, where practicable, of the comparative information on the face of the financial statements. The allowed alternative treatment requires a revenue or an expense to be recognised in the reporting period in which the fundamental error is discovered where the amount is reasonably determinable. Comparative information is not restated on the face of the financial statements but is restated in the notes.

Australia

E4 ED 93 proposes adoption of the IAS 8 requirement on *changes in estimates*. It also proposes adoption of the additional disclosures under the allowed alternative approach in IAS 8 for *fundamental errors* in the belief that all items of revenue and expense should be recognised in the statement of financial performance in the reporting period in which they are discovered, if this is after the period in which they arise.

Canada

E5 Under Section 1506, the effect of a *change in estimate* should be recognised in the reporting period of the change if the change affects that period only, or in the period of the change and future periods if the change affects both. No distinction is made between degrees of *error*, although errors and changes in estimate are distinguished. The correction of an error in prior period financial statements should be accounted for by restating the prior periods.

New Zealand

E6 Under FRS-7, since a *change in estimate* arises from new information or developments, it is not to be given retrospective effect by a restatement of prior periods. On *fundamental errors*, FRS-7 states that an error is considered to be fundamental where it is so significant that it destroys the fair presentation of the financial report taken as a whole. The correction of a fundamental error is accounted for by restating the prior period(s) with the result that the opening balance of retained earnings is adjusted accordingly.

UK

E7 FRS 3 excludes *changes in estimates* from its definition of items for which prior period adjustments should be made (ie retroactive application and restatement). In consequence, a change in an estimate in a subsequent period is recognised in the period of change only and prior period financial statements are not affected.

E8 In FRS 3 the correction of *fundamental errors* is treated as a prior period adjustment, with the accounting treatment as described in paragraph E3 above, except that the balance on retained earnings at the beginning of the earliest period presented (rather than the current period) is restated to reflect the cumulative effect of the change on prior periods.

USA

E9 Changes in accounting estimates are seen as arising from the occurrence of new events or the acquisition of additional information. They are not treated as prior year adjustments. These are distinguished from errors. The correction of an error (by implication, only material errors) in previously issued financial statements is an accounting change that should be treated as a prior period adjustment. Prior period adjustments are reflected as adjustments to the amount of net income, its components, retained earnings, balances, and other affected balances for all the periods presented to reflect the retrospective application of the prior period adjustments.

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