FINANCIAL REPORTING

EXPOSURE DRAFT

PROPOSED AMENDMENT TO FRS 3 'REPORTING FINANCIAL PERFORMANCE'

ACCOUNTING
STANDARDS
BOARD

For ease of handling, we prefer comments to be sent by email (in Word format) to

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Comments should be despatched so as to be received no later than 27 April 2007. All replies will be regarded as on the public record, unless confidentiality is requested by the commentator.

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The draft is issued by the Accounting Standards Board for comment. It should be noted that the draft may be modified in the light of comment received before being issued in final form.

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PREFACE

Introduction

1. This Exposure Draft proposes limited amendments to Financial Reporting Standard (FRS) 3 *Reporting Financial Performance* to clarify its application to entities within the scope of FRS 26 (IAS 39) *Financial Instruments: Recognition and Measurement.*

2. In summary the proposed changes to FRS 3 are:

   a. to reflect the exemption from certain paragraphs of FRS 3 for entities applying FRS 26 and FRS 23 (IAS 21) *The Effects of Changes in Foreign Exchange Rates;* and

   b. to delete references in paragraph 55 to exemption from producing a profit or loss on an unmodified historical cost basis for certain market makers and other dealers of investments where marking to market is the industry practice.

The ASB's proposals

3. FRS 26 specifies the treatment of gains and losses on remeasurement and derecognition of financial instruments. Paragraphs 21, 26 and 31A of FRS 3 specify the treatment of such gains or losses for all assets and liabilities. It has been suggested that there is a conflict. For example, unrealised gains and losses on available-for-sale financial assets of insurance entities within the scope of FRS 26 are required by that standard to be recognised in the statement of total recognised gains and losses and recycled through the profit and loss account on realisation. Paragraph 31A of FRS 3, on the other hand, requires that all investment portfolio gains and losses be included as part of the investment return in the profit and loss account. Whilst FRS 26 is the later

and more specific standard the ASB thinks that it would be more helpful to clarify the situation.

4. On 2 January 2007 the Urgent Issues Task Force (UITF) issued UITF Information Sheet 81, recommending that the ASB make a limited amendment to FRS 3 which it considered, if implemented, will be applicable to UK entities within the scope of FRS 26.

5. The UITF's recommendation was that FRS 3 should clarify that paragraphs 21, 26 and 31A of the standard do not apply to the financial instruments of entities within the scope of FRS 26.

6. During its deliberations the ASB also noted a related problem for entities complying with the requirements of FRS 23 (IAS 21) *The Effects of Changes in Foreign Exchange Rates*. On the disposal of a foreign operation paragraph 48 of FRS 23 requires that the cumulative amount of related exchange differences recognised in the STRGL be recycled through the profit or loss. FRS 23 would require recycling of the foreign exchange gain. Therefore, entities complying with the requirements of FRS 23 would need similar clarifications to that being proposed for entities within the scope of FRS 26, in relation to the foreign exchange gain or loss on sale of a foreign operation.

7. The ASB, however, is against recycling as a principle and does not want to be seen to promote it as a concept. It does, however, acknowledge that a problem exists for entities within the scope of FRS 26 and FRS 23 as set out above. Accordingly, it has proposed a limited amendment to the scope of FRS 3 that allows an exemption from paragraphs 21 and 31A of the standard only to the financial instruments of entities within the scope of FRS 26 and the foreign exchange differences on the sale of a foreign operation for entities within the scope of FRS 23.

8. Amendments are also proposed to the requirements relating to the note of historical cost profits and losses in paragraphs 26 and 55 of FRS 3 to allow the omission of the effect of fair value accounting of all financial instruments under FRS 26, not just market makers and other dealers in investments as is currently the case under FRS 3. The amendment to paragraph 26 also has the effect of requiring an additional disclosure to the note on historical cost profits and losses; namely the fact that the effects of fair value accounting for financial instruments and hyperinflationary adjustments have been excluded from the reconciliation of the reported profit on ordinary activities before taxation to the equivalent historical cost amount.

9. The ASB decided that it would be more appropriate to amend FRS 3 rather than FRS 23 and FRS 26 as they are standards which are converged with the equivalent International Financial Reporting Standards (IFRS).

10. The ASB has also taken this opportunity to delete an unrelated example in the 'Illustrative Examples' section which is no longer applicable in the UK as the related paragraphs in the standard had been removed previously.

Regulatory impact

11. The ASB is not aware that the proposal would impose additional costs on entities that would outweigh the benefits of providing this clarification, but would welcome any comments that respondents might have on this issue.

Date from which effective

12. It is proposed that the [draft] FRS is effective for accounting periods beginning on or after 1 January 2007. Early adoption is permitted.

Invitation to comment

13. The ASB is requesting comments on any aspect of the Amendment to the FRS by 27 April 2007. Given the urgency of the issue, this is a shorter than normal consultation period.

14. The ASB would welcome comments in particular on the following:

Q1 Do you agree that the proposed amendment is a useful clarification? If not, why not?

Q2 Are you aware of any problems that may arise as a result of the proposed amendments for entities that are not meant to be within the scope of this amendment?

Q3 Are you aware of any other conflicts with FRS 3 that should be addressed at the same time as those stated in this Exposure Draft?

Q4 Do you agree that the benefits of the proposed amendment would outweigh any costs involved? If not, why not? It would be helpful if any significant costs that would arise on implementation of the proposal could be identified and quantified.

Q5 The ASB is proposing that the [draft] FRS be effective for accounting periods beginning on or after 1 January 2007 and it is permitting early adoption. Do you agree with the proposed effective date?

[DRAFT] FINANCIAL REPORTING STANDARD

Amendment to FRS 3 'Reporting Financial Performance'

1 **Amend paragraph 12 as follows:**

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

2 **Insert new paragraph 12B as follows:**

12B Paragraph 21 and the last sentence of paragraph 31A of the FRS do not apply to entities adopting FRS 26 (IAS 39) *Financial Instruments: Recognition and Measurement,* in relation to:

a. financial instruments accounted for in accordance with FRS 26; and

b. foreign exchange differences on disposal of a foreign operation in accordance with FRS 23 (IAS 21) *The effects of changes in foreign exchange rates.*

3 **Insert a new sentence into paragraph 26 as underlined:**

26 Where there is a material difference between the result as disclosed in the profit and loss account and the result on an unmodified historical cost basis, a note of the historical cost profit or loss for the period should be presented. Where full historical cost information is unavailable or cannot be obtained without

unreasonable expense or delay, the earliest available values should be used. The note of the historical cost profit or loss should include a reconciliation of the reported profit on ordinary activities before taxation to the equivalent historical cost amount and should also show the retained profit for the financial year reported on the historical cost basis. The effects of fair value accounting under FRS 26 and hyperinflation adjustments under FRS 24 (IAS 29) *Financial Reporting in Hyperinflationary Economies* and UITF Abstract 9 *Accounting for Operations in Hyper-inflationary Economies* are not required to be included in this reconciliation, but this omission should be noted. The note should be presented immediately following the profit and loss account or the statement of total recognised gains and losses.

4 **Insert a new sentence into paragraph 55 as underlined and delete the last sentence after "paragraph 26" as follows:**

55 Two reasons for disclosing the profit or loss for a period on the unmodified historical cost basis of accounting are commonly cited. The first is, that for as long as discretion exists on the timing or scale of revaluations included in financial statements, the unmodified historical cost basis will give the reported profits or losses of different reporting entities on a more comparable basis. The second is the wish of certain users to assess the profit or loss on sale of assets based on their historical cost, rather than, as the FRS requires, on their revalued carrying amount. In acknowledgement of these concerns, the Board has made the provision of a note of historical cost profits and losses a requirement of the FRS in those circumstances where there is a material difference between the result as disclosed in the profit and loss account and the result on an unmodified historical cost basis. Where full historical cost information is unavailable or cannot be obtained

without unreasonable expense or delay, the earliest available values should be used. The note of historical cost profits and losses should be presented immediately following the profit and loss account or the statement of total recognised gains and losses. In consolidated financial statements, the profit and loss account figure for minority interests should be amended for the purposes of this note to reflect the adjustments made where they affect subsidiary companies with a minority interest. For the purpose of paragraph 26 the fair value accounting adjustments necessary under FRS 26 and hyperinflation adjustments under FRS 24 and UITF Abstract 9 are not required to be included in the reconciliation, but this omission should be noted. ~~the following are not deemed to be departures from the historical cost convention: (a) adjustments necessarily made to cope with the impact of hyper-inflation on foreign operations and (b) and the practice of market makers and other dealers in investments of marking to market where this is an established industry practice~~.

5 **Insert a new footnote at the end of paragraph 56 as follows:**

ASB footnote: However, for entities applying FRS 26, which is based on the International Accounting Standard 39 *Financial Instruments: Recognition and Measurement*, gains and losses on remeasurement of certain categories of financial instruments are recognised in the STRGL and the related cumulative gain or loss is recognised in the profit and loss account when the instrument is derecognised.

6 **The last example in the Illustrative Examples section headed 'Companies Act investment company' is deleted.**

7 **The following subheading and paragraph is added to the Development of the Standards section**

2007 Amendment

xii During 2007 the ASB set out to clarify the relationship between FRS 3 requirements and those contained in FRS 23 and FRS 26. FRS 26 specifies the treatment of gains and losses on remeasurement and derecognition of financial instruments. Paragraphs 21, 26 and 31A of FRS 3 specify the treatment of such gains or losses for all assets and liabilities, including financial instruments. Similarly, entities complying with FRS 23 are required by paragraph 48 of the standard to recycle the cumulative amount of exchange differences relating to a foreign operation, recognised in the statement of total recognised gains and losses, through the profit or loss on the disposal of that foreign operation. In contrast, FRS 3 appears to specifically prohibit this recycling through the profit and loss account. Whilst FRS 26 and FRS 23 are the later and more specific standards the ASB decided to clarify the situation by amending the scope of FRS 3.

8 **An entity shall apply this [draft] Amendment to FRS 3 for accounting periods beginning on or after 1 January 2007. Early adoption is permitted.**

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