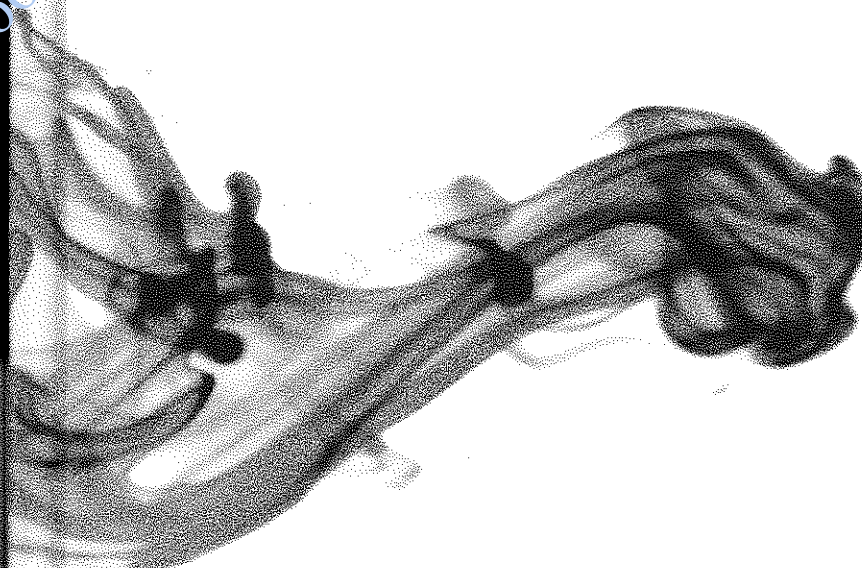

*Manual of
accounting*
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Index

1. Introduction
 2. Accounting principles and applicability of IFRS
 3. First-time adoption of IFRS
 4. Presentation of financial statements
 5. Accounting policies, accounting estimates and errors
 6. Hyper-inflation
 7. Foreign currencies
 8. Insurance contracts

9. Revenue and construction contracts
 10. Segment reporting
 11. Employee benefits
 11A. Employee benefits (IAS 19 revised)
 12. Share-based payment
 13. Taxation
 14. Earnings per share

15. Intangible assets
 16. Property, plant and equipment
 17. Investment property
 18. Impairment of assets
 19. Lease accounting
 20. Inventories
 21. Provisions and contingencies
 22. Events after the reporting period and financial commitments
 23. Share capital and reserves

24. Consolidated and separate financial statements
 24A. Control
 25. Business combinations
 26. Disposals of subsidiaries, businesses and non-current assets
 27. Equity accounting
 28. Joint ventures
 28A. Joint arrangements

Contents

Abbreviations and terms used..... P011

Accounting rules and principles

1 Introduction 1001
 2 Accounting principles and applicability of IFRS 2001
 3 First-time adoption of IFRS 3001
 4 Presentation of financial statements 4001
 5 Accounting policies, accounting estimates and errors 5001
 6 Hyper-inflation 6001
 7 Foreign currencies 7001
 8 Insurance contracts 8001

Income statement and related notes

9 Revenue and construction contracts 9001
 10 Segment reporting 10001
 11 Employee benefits 11001
 11A Employee benefits (IAS 19 revised) 11A001
 12 Share-based payment 12001
 13 Taxation 13001
 14 Earnings per share 14001

Balance sheet and related notes

15 Intangible assets 15001
 16 Property, plant and equipment 16001
 17 Investment property 17001
 18 Impairment of assets 18001
 19 Lease accounting 19001
 20 Inventories 20001
 21 Provisions and contingencies 21001
 22 Events after the reporting period and financial commitments 22001
 23 Share capital and reserves 23001

Consolidated financial statements

24 Consolidated and separate financial statements 24001
 24A Control 24A001
 25 Business combinations 23001
 26 Disposals of subsidiaries, businesses and non-current assets 26001
 27 Equity accounting 27001
 28 Joint ventures 28001
 28A Joint arrangements 28A001

Global harmonisation — IFRS and US GAAP

1.5 Global harmonisation, then, is what the IASB is all about. But true global harmonisation would include not only the impressive array of countries just mentioned but also the USA. The IASB cannot claim to be *the* global standard setter as long as the FASB sets rules for the US markets.

1.6 Things started to change, first, with the IASB/FASB ‘Norwalk Agreement’ of 2002; and then with the announcement in July 2007 by the US SEC of two important initiatives relating to US GAAP and IFRS. The first was that, at the end of 2007, the SEC introduced a new rule dropping the ‘US GAAP reconciliation’ – that is, the reconciliation required to be given by foreign private issuers (FPIs) from home country GAAP, which is often IFRS, to US GAAP. These reconciliations were a cost and burden to FPIs and yet the general view was that hardly any use is made of them by investors or others. We should note, however, that the SEC said that the home country GAAP – the principal financial reporting convention – should be IFRS as issued by the IASB, not another variant of IFRS.

1.7 This alone was a big step, but the second part of the July 2007 announcement was potentially more far-reaching. The second development was that the SEC proposed that IFRS might be permissible in the US markets as an alternative to US GAAP. The timescale is extended. At the time, they indicated that the decision might be confirmed in 2011, with implementation perhaps as soon as 2014, though potentially later, and subject to various conditions. A formal announcement from the SEC is still expected at the end of 2011. In the meantime, an SEC staff announcement in May 2011 may give us some clues. The staff outlined a possible approach, which was termed ‘condorsement’, evidently a mixture of convergence and endorsement. The SEC and FASB would remain in place with authority to set standards for the US markets, but US GAAP and IFRS would gradually converge such that, in time, the two would be similar or the same. Whether it will emerge in this way can only be, at this stage, a matter of speculation.

1.8 Many questions arise from these potential developments:

- Given their years of reliance on detailed prescription under US GAAP, how easy would US accountants find the change to IFRS?
- Would US GAAP survive at all in the medium and longer-term?
- Would the US influence on the IASB increase, as the US would be a major constituency? Would the IASB still have convergence with US GAAP as an objective, or would it be just the FASB that had an objective of convergence?
- What attitude will the SEC take to the enforcement and interpretation of IFRS and what will be the implications of this for the rest of the world?

■ What does this mean for the complexity and degree of prescription in the IFRS of the future? It will be some years before the answers to these questions become clear.

1.9 Co-operation between the two boards has increased since 2007, with frequent joint board meetings, adoption of the same standards in some areas (for example, operating segments, business combinations) and joint working towards convergence on other subjects, such as financial instruments and revenue recognition. Nevertheless, the boards do not always agree, as the current different proposals on financial instruments show. Despite this, the boards are working towards completion of what are now called ‘the big four’ – revenue, leasing, financial instruments and insurance. The objective had been to finish these converged standards by June 2011 – not least as that was the date when Sir David Tweedie handed over to the new IASB chairman, Hans Hoogervorst. However, the complexities and disagreements were such that none of the four were finished and indeed the new IASB board has announced that revenue and leasing will be re-exposed before they are finalised.

1.10 It is perhaps too early to tell to what extent the change of chairman will herald a change of strategy. An early sign lies in the IASB’s July 2011 formal public consultation on its work programme. This is a first. It is also quite possible that the new chairman will see convergence with US GAAP as being less important than did his predecessor.

1.11 The close co-operation with the FASB and the SEC’s recent move towards introducing IFRS into the USA seem to be steps that should be welcomed as the final stages of global harmonisation of accounting. If only it were so straightforward. Certainly, the Norwalk Agreement was strategically a highly important step to harmonise accounting around the world. For a year or two after the Agreement was made in 2002, it seemed so obviously right that to challenge its basis would have been heretical. More recently, that view has started to change. As the world has seen more of the effects of harmonisation, it has begun to ask whether incorporating aspects of US GAAP into IFRS is actually the good idea that it seemed. This is not to say that harmonisation has been a one-way track. Indeed there are many examples where the FASB is changing its standards to adopt IFRS solutions. But despite that, there is a perception that IFRS is suffering from two things: first, the importing of specific US rules and secondly the adoption of US-style detailed prescription. The US has been setting detailed accounting rules for over 70 years and recent decades have witnessed more and more detailed rules being written in response to the combination of a complex business environment and a litigious society. US GAAP may not be perfect, but it does suit the US environment – where it is written essentially for listed (that is, SEC-registered) companies. Hence, a problem with IFRS/US GAAP harmonisation is that US GAAP is in danger of being exported, *via* IFRS, to many countries that have a different business environment to the USA, have smaller economies and a smaller accounting infrastructure. In many of those countries it is often being applied across the whole economy, not just to the listed

sector. So, there is a potential problem of unsuitability of standards for the contexts in which they are being applied. It is important, therefore, that the IASB remembers that convergence with US GAAP, although an important objective, should not be carried out in such a way as to make its standards unsuitable for its widespread and varied constituency.

1.12 In this regard, the IASB's recent work on developing a form of IFRS for small and medium-sized entities (SMEs) is particularly important. The IFRS for SMEs was published in July 2009 and is intended, despite its somewhat inaccurate name, for those entities that are not publicly accountable. It is up to each country to decide whether to use IFRS for SMEs, and when; and to decide to whom it would apply or be available. In comparison with full IFRS, the IFRS for SMEs has somewhat simplified recognition and measurement rules and reduced disclosures. A number of territories have adopted full IFRS for the whole economy and are finding it overly complex for the non-publicly-accountable sector. Hence, they have welcomed the IFRS for SMEs. Early signs are encouraging though it is too early to say exactly how many countries will use it. But in principle it allows the IASB to offer to a vast number of companies world-wide a set of standards in a form that is suitable to their scale and sophistication. The IFRS for SMEs may also be useful at the national level. That is, some countries may not want to adopt, in place of national GAAP, the full rigours of IFRS, but may consider that IFRS for SMEs is suitable for the unlisted sector to which national GAAP often applies. So, while the world's listed and public interest companies will stay with, or adopt full IFRS, there is likely to be a much bigger adoption, measured by number of companies, of IFRS for SMEs.

The EU and politics

1.13 The EU Regulation of 2002 required listed groups to prepare their consolidated financial statements using IFRS for periods commencing on or after 1 January 2005. The Regulation introduced a permissive regime for other entities. As noted above, this regulation was a major step for Europe and for the IASB – as well as being an encouragement for other territories to adopt IFRS. EU adoption of IFRS is good news for harmonisation, but with an important proviso. The EU needs to bring IFRSs into EU law and it cannot do so without a formal process of adoption. To achieve this, it has developed a complex 'endorsement mechanism'. This comprises the Commission; an official Accounting Regulatory Committee (ARC); and a private sector body – the European Financial Reporting Advisory Group (EFRAG) – which works with the IASB to ensure full understanding of the European viewpoint and advises the Commission and the ARC.

1.14 The endorsement mechanism is proving to be, at best, a mixed blessing. Most of the IASB's standards have been endorsed, though IAS 39, 'Financial instruments: Recognition and measurement', was not endorsed in full. After a lengthy process that owed more to politics than to accounting, a so-called 'carve-out' version of IAS 39 was approved. That is, the November 2004 EU-endorsed

version of IAS 39 excluded a few paragraphs to which some EU banks objected. These paragraphs are a small part of only one standard, but politically they are highly significant, as they show that the IASB cannot take EU-endorsement for granted. Politically, the process is highly significant as it introduces the prospect that, with one or more future standards, there may emerge a more fundamental difference between EU-IFRS and IFRS as promulgated by the IASB.

1.15 The second effect of the EU endorsement process is that it introduces delay and uncertainty. It has tended to take about six to ten months, after a standard has been finalised by the IASB, for it to be endorsed by the EU. This makes it difficult for companies to know whether a particular new or amended standard, or interpretation from the IFRS IC, will be endorsed and available to be applied at an imminent year end.

1.16 In a broader context, politics and accounting – for long only occasional bedfellows – have been interacting more since 2009. Specifically, the G20 heads of state and finance ministers have taken an interest in accounting, as part of their work on trying to stabilise the global financial system. They have put pressure on the IASB and the FASB to accelerate their work on improving and simplifying IAS 32, 'Financial instruments: Presentation', and IAS 39. A result of this is that the two boards are working hard on the reform of financial instrument accounting – but doing so in bits. Papers appear on fair value measurement; then on classification and measurement; then on impairment; then on hedge accounting; and so on. This is far from ideal, as the pieces of the jigsaw interact in complex ways. Certainly the process of improving these standards is taking longer than the G20 had in mind.

Preparers and users of financial statements

1.17 Looking back on first-time adoption in the EU and elsewhere, we can see that experience with the new IFRS information has been mixed. Some analysts were, inevitably, better prepared than others. Some company finance teams had prepared better than others. Some companies were affected more fundamentally than others. Companies are required by the first-time adoption rules in IFRS 1 to publish reconciliations of profit and net assets as between national GAAP and IFRS. For many companies, the aspects of converting to IFRS that had the biggest numerical impact on profit measurement were goodwill (no longer having an amortisation charge) and share-based payment (starting to have an IFRS 2 charge against profits). A lot of companies were affected by IASs 32 and 39 on financial instruments, especially in the banking and insurance sectors. Other subjects were more of a surprise. For example, there were more implementation problems and profit and balance sheet effects arising out of lease accounting and foreign currency rules than had been expected. All this is starting to read like history for countries that adopted IFRS in 2005. But countries in the next wave of transitioning territories are now starting to encounter the same issues. They are, at least, better off in that they can learn from the experience of the 2005-wave of transitions.

1.18 But an important distinction can be seen overall between the attitudes of preparers and users. Experience in the EU has been that finance directors and other preparers were relatively negative towards IFRS in the sense that they saw considerable cost and work in performing the conversion; and they saw a result that was different rather than better. Some preparers took the view that the results under IFRS were not as realistic a representation of underlying performance as under national GAAP. Users – fund managers, analysts and others – were more positive. They did not directly incur the costs and the work of conversion, though they did have to become familiar with a new GAAP. But they see the fruits of harmonisation much more than preparers do, as they are the beneficiaries of comparable information for the economy, or for the sector that they follow. A trend of the last three years is that of user groups becoming much more involved in the standard-setting process. A leading example of this is the Corporate Reporting User Forum (CRUF).

1.19 This is not to say, however, that standard setters and companies are giving users exactly what they want. Accounting information is intended to be useful to users of financial statements in making economic decisions. But the recent and imminent reforms will bring new challenges as well as new information. Something of a polarity is already noticeable. Three examples illustrate this. First, standard-setters are working towards a more comprehensive notion of performance, incorporating both transaction-based realised profits and a wider range of value changes than before. Both of those elements of performance will display volatility. At the same time, companies want to give analysts, and analysts seemingly want to receive, information that is (a) close to cash flows and (b) stable and useful as a predictor of future results. Hence the popularity of EBITDA and ‘adjusted earnings’ and ‘adjusted EPS’ of different types. Numbers of this type are perfectly valid, but need to be placed in context; it is important that they are not given more prominence than the GAAP numbers.

1.20 A second example where standard-setters and users are not aligned is in the vexed area of fair value accounting. Some of the thinking and proposals by the IASB and FASB in the last three years suggest that the standard-setters are pursuing a medium and longer-term agenda of more fair value information. Yet this is not necessarily what many users want. Certainly, users are interested in fair value information for many assets and liabilities, but this does not, from their point of view, need to be on the balance sheet: some can be given adequately in the footnotes. At an extreme, if all assets and liabilities, including inherent goodwill, were to be fair valued, the result might, in principle, be the value of the entity. But most users would balk at this, saying that it is their job to value the entity and its shares, not the role of accounting information to do so. Of course, this extreme is highly unlikely to be reached in reality, due to limits on what assets and liabilities can be recognised and on what can be valued satisfactorily.

1.21 The third example is the extent of disclosure. The increasing level of disclosure required by IFRS, together with other factors, has led to annual reports becoming longer and longer. This is a concern to those who have to prepare financial statements. Conversely, analysts seem to want more and more

information and new accounting standards push practice in the same direction. But the growing list of disclosures is a concern to the IASB. They commissioned a study in 2011 that was carried out jointly by the Scottish and New Zealand Institutes of Chartered Accountants. The report – ‘Losing the excess baggage – reducing disclosures in financial statements to what’s important’ – was published in August 2011. Their conclusion was that as much as 30 per cent of the content of financial statements could be deleted without serious consequences.

Conclusion

1.22 The adoption of IFRS reporting has given rise to new challenges both as regards the accounting principles (recognition and measurement) and matters of presentation and disclosure. IFRS is used increasingly by companies throughout the world. It is important that the interpretation and application of IFRS is consistent from country to country. We hope that this Manual will be helpful to those wishing to understand IFRS and its consistent, practical application. For the avoidance of doubt, this Manual deals with full IFRS, not IFRS for SMEs.

1.23 The PricewaterhouseCoopers’ Manual of Accounting – Financial Instruments forms part of this Manual of Accounting but is now published in a separate book, which accompanies this Manual.

UK.1.24 Throughout this book paragraphs styled like this have been added to the text to explain the implications of the guidance for UK companies and groups that adopt IFRS. These additional paragraphs often cover the rules that UK companies and groups have also to comply with that are included primarily in the Companies Act 2006 and the FSA’s Listing Rules.

UK.1.25 The PricewaterhouseCoopers’ Manual of Accounting – Narrative Reporting supports this manual by providing UK companies with guidance on the ‘front half’ of the financial statements.

Accounting conventions	2041
Capital maintenance concepts	2041
Valuation bases	2042
Units of measurement	2042
Conventions	2043
Historical cost convention	2043
Modified historical cost convention	2043
Modified Historical cost/Fair value convention	2044
Current purchasing power	2044
Current cost accounting	2044

Chapter 2

Accounting principles and applicability of IFRS

Introduction

2.1 This chapter introduces the concepts underlying accounting practices that are discussed in greater detail throughout this book as they relate to particular accounting issues and problems. These concepts are set out under IFRS in the IASB's 'Conceptual Framework for Financial Reporting' issued in September 2010 (the Framework). It supersedes the 'Framework for the preparation and presentation of financial statements' (the Framework (1989)).

GAAP in the UK

The composition of GAAP in the UK

UK.2.1.2 The components of GAAP in the UK vary according to the type of company or entity. However, generally there are components that are mandatory (in law or in practice) and components that are not mandatory. The core mandatory components are set out in the following paragraphs.

UK.2.1.3 For those companies applying IFRS, GAAP in the UK is:

- The Companies Act 2006, insofar as it applies to entities adopting IFRS (see from para UK.2.1.38).
- Accounting standards that have been adopted by the EU (see from para 2.10.54). These standards are some or all of the following:
 - International Accounting Standards (IASs).
 - International Financial Reporting Standards (IFRSs).
- Interpretations that have been adopted by the EU. That is:
 - Interpretations developed originally by the Standing Interpretations Committee (SIC).
 - Interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC).
- For listed companies, the Listing Rules and the Disclosure and Transparency Rules.

UK.2.1.3.1 The IASB has also published IFRS for Small and Medium-sized Entities (SMEs). This is a standalone suite of standards tailored for non publicly accountable entities as opposed to a standard within the sphere of the

main IFRS framework. IFRS for SMEs is not currently available for UK companies preparing financial statements under IFRS. See further from paragraph 2.5.1.

UK.2.1.4 Other components of GAAP in the UK for those applying IFRS will be authoritative to varying degrees but non-mandatory. These include:

- The IASB's Framework. The Framework does not have the status of an accounting standard. Nevertheless, it is authoritative in two senses. First, it provides a frame of reference to guide the IASB in its development of standards. It should help guide companies and auditors as to the meaning and intention of individual standards if they are unclear. Secondly, the Framework provides a reference for the accounting treatment of transactions for which there is no specific GAAP.
- Statements issued by the ASB that are relevant for UK companies reporting under IFRS.
- Statements and recommendations from the professional bodies, such as ICAEW Technical Releases and accounting recommendations. Professional bodies' accounting-related statements are unlikely to address the interpretation of IFRS, but they will still be relevant in the context of company law issues.
- Established practice. Practices that are generally accepted, even though not codified in official literature, can be regarded as part of GAAP in the UK. An example of this is the guidance in this Manual of Accounting.

UK.2.1.5 UK Financial Reporting Standards (FRSs) and Statements of Standard Accounting Practice (SSAPs) do not apply to entities using IFRS. However, IAS 8, 'Accounting policies, changes in accounting estimates and errors', contains guidance on the selection of accounting policies. In the hierarchy of selection, management should first consider IFRSs and interpretations of IFRSs. If there is no standard or interpretation in the relevant area, management should develop a policy that addresses the decision-making needs of users and that is reliable. [IAS 8 para 10].

UK.2.1.6 In doing so, the entity should consider (in this order):

- Requirements and guidance in other international standards and interpretations dealing with similar issues.
- The content of the IASB's Framework (see from para 2.1.1).

[IAS 8 para 11].

UK.2.1.7 After referring to the items in paragraph UK.2.1.6, management may consider the pronouncements of other standard-setting bodies that use a similar conceptual framework to the IASB's, other accounting literature (such as this Manual of Accounting) and industry practices, as long as they do not

conflict with the sources of guidance outlined in paragraph UK.2.1.6. [IAS 8 para 12].

UK.2.1.8 Some FRSs and SSAPs may address topics not covered by IFRSs and serve as a reference where IFRSs are silent.

UK.2.1.9 Certain industry groups in the UK develop Statements of Recommended Practice ('SORPs'). These give guidance on the application of accounting standards to specialised industries and non-profit-making sectors. SORPs cannot override the requirements of IFRS. However, the SORP may fit into the hierarchy for selecting accounting policies (see para UK.2.1.5) as additional guidance in areas that are not covered by IFRS, as long as that guidance does not contradict IFRS, interpretations of IFRSs or the Framework.

UK.2.1.10 The sectors for which SORPs are in issue are:

- Authorised funds.
- Charities.
- Further and higher education institutions.
- Insurance.
- Investment trusts.
- Local authorities.
- Oil and gas.
- Pension schemes.
- Registered social landlords.
- Unit trusts.
- Leasing.
- Open-ended investment companies (OEICs).
- Limited liability partnerships.

UK.2.1.11 The output of the Financial Reporting Review Panel (FRRP), the enforcer of financial reporting in the UK, constitutes part of GAAP in the UK. The FRRP does not issue rules but announces its findings in relation to individual companies or groups and makes statements of more general application (see from para UK.2.1.65). These companies generally change their accounting practices or give additional disclosure, following discussion with the FRRP. The FRRP usually issues formal statements only where companies have deviated from existing requirements of UK company law or accounting standards. However, in some cases, the FRRP's views have added to, or modified, the previous understanding of UK GAAP and IFRS. Companies and auditors should take heed of the FRRP announcements.

[The next paragraph is UK.2.1.13.]

Applicability of IFRS in the UK

EU Regulation on IFRS

UK.2.1.13 All listed companies in the EU (including banks and insurance companies) have been required to prepare consolidated financial statements under EU-adopted IFRS since financial years beginning on or after 1 January 2005 under the 'EU 2005 Regulation'. The Regulation permits Member States to extend the requirement to use IFRS to unlisted groups and to individual company financial statements (see from para UK.2.1.20 onwards) and the UK permits this.

UK.2.1.14 Listed companies in this context means any companies that, at the balance sheet date, have securities admitted to trading on a regulated market of any member state. Securities in this context include debt as well as shares.

UK.2.1.15 Regulated markets in the UK are the following:

- London Stock Exchange – Regulated Market
- The London Metal Exchange
- ICE Futures Europe
- SWX Europe Limited
- The London International Financial Futures and Options Exchange (LIFFE)
- EDX
- PLUS-listed Market

UK.2.1.16 AIM is not included in the above list, because it ceased to be a 'regulated market' in 2004. AIM companies are not subject to the EU 2005 Regulation that requires them to prepare financial statements under IFRS. However, the AIM rules require companies that have subsidiaries and are incorporated in any EEA member state, the Isle of Man or the Channel Islands to apply EU-adopted IFRS.

UK.2.1.17 The 2005 Regulation applies to the *consolidated* financial statements of entities with securities admitted to trading on a regulated market. Entities should first examine whether they are required to prepare consolidated financial statements under the 7th Directive, set out in UK law in sections 399 to 403 of the Companies Act 2006 and described in chapter 24. Entities that are not required to prepare such financial statements under EU law are outside the Regulation's scope. This is the case whether or not IFRS would require consolidated financial statements.

UK.2.1.18 The 7th Directive sets out certain exclusions from consolidation (transposed to UK law in sections 402 and 405 of the Companies Act 2006). However, these exclusions are not relevant to companies to whom the 2005 Regulation applies. Adopted IFRSs will set out the scope of the consolidated financial statements – that is, which entities should be included and how they should be accounted for. [EU clarification para 2.2.2(c)].

UK.2.1.19 The scope of the 2005 Regulation applies only to companies governed by a law of a Member State. This means that, for example, a US company that has a listing on the London Stock Exchange does not have to prepare consolidated financial statements under IFRS.

Extension of the EU Regulation

UK.2.1.20 The EU 2005 Regulation allows Member States to extend the requirement to use IFRS to unlisted groups and to individual company financial statements. All UK companies (except charitable companies) and building societies are permitted to use EU-adopted IFRS in their individual and/or consolidated financial statements. However, there are some restrictions and conditions:

- Once a company has prepared its financial statements under EU-adopted IFRS, it cannot revert to UK GAAP in a later financial year, unless there is a 'relevant change in circumstance'. A relevant change in circumstance occurs if the company becomes a subsidiary of an undertaking that is not preparing its individual financial statements under EU-adopted IFRS or if the company (or its parent) ceases to have its securities traded on a regulated market. [CA06 Sec 395(3)].
- A parent company may elect to prepare its individual financial statements under UK GAAP even if it uses EU-adopted IFRS in its consolidated financial statements.
- Where the parent company prepares group accounts, the directors of the parent company have a responsibility to ensure that all UK subsidiaries in the same group adopt the same accounting framework as each other, unless there are 'good reasons' not to do so. The parent should ensure that all UK companies in the group use either EU-adopted IFRS or UK GAAP. However, where a parent adopts EU-adopted IFRS in both its consolidated financial statements and its individual financial statements, it will not be required to ensure that all its subsidiaries use EU-adopted IFRS too. [CA06 Sec 407(5)]. The Department for Business, Innovation and Skills (the BIS) issued guidance notes on these rules, including an explanation of when there might be 'good reasons' (see para UK.2.1.21).
- Building societies are subject to the same requirements as companies in that they have the option of adopting IFRS in their individual and consolidated financial statements.

- Charitable companies may not prepare financial statements under IFRS. IFRS does not specifically address charity sector transactions and the government believes that the direct application of IFRS without modification through a SORP might create 'interpretational issues'. In addition, there are no plans to permit unincorporated charities to use IFRS.

UK.2.1.21 The BIS has issued guidance to help companies apply these rules. These include an explanation of where there might be 'good reasons' for the directors not to prepare all the individual financial statements within a group by using the same accounting framework. The provision allows a degree of flexibility where there are genuine, including cost/benefit, grounds for not using the same framework. Such reasons include:

- An IFRS group acquires a subsidiary that does not use IFRS. In the year of acquisition, it might not be practicable for the newly-acquired subsidiary to move to IFRS straight away.
- A group might include subsidiaries that are themselves publicly traded. In this case, market pressures or regulatory requirements to use IFRS might come into play, without necessarily justifying a move to IFRS by the non-publicly traded subsidiaries.
- Where a subsidiary or a parent is planning to list and might wish to convert to IFRS in advance, but the rest of the group is not intending to list.
- The group might include small subsidiaries where the cost of moving to IFRS might outweigh the benefits.

If the parent's directors adopt a different framework for any entities within the group, they should be able to justify any inconsistency to shareholders, regulators or other interested parties.

UK.2.1.22 The BIS guidance does not mention tax as a 'good reason' for adopting a different framework for one or more UK subsidiaries within a group. In commercial terms tax is a business cost like any other. We have sought advice from legal counsel as to whether tax may be a good reason. The question is one of degree, depends on individual facts and circumstances, and the directors must weigh up various matters in reaching their conclusion.

UK.2.1.23 In the case of existing arrangements or structures, where a transition from UK GAAP to EU-adopted IFRS would result in a significant increase or potential volatility in taxable profits, or a significant acceleration of tax cash outflows, or introduce a significant new tax exposure, compared with the company continuing to use UK GAAP, the tax consequences may be a 'good reason' to keep one or more subsidiaries on UK GAAP. For example, a company's revenue recognition might be accelerated under IFRS, accelerating tax payments. 'Significant' in this context might be in absolute terms or relative

to the company's size. A trivial tax effect should not be used as an excuse to keep a company on UK GAAP. Similarly, if, as a result of a company using EU-adopted IFRS, the group could no longer claim the benefits of existing tax planning (or the benefits would be significantly reduced or new tax risks would arise under EU-adopted IFRS such that the planning would not have been entered into with companies using EU-adopted IFRS) the tax effect of using EU-adopted IFRS may be a good reason for one or more subsidiaries to remain on UK GAAP. However, as noted above it is also necessary to weigh up other matters in reaching the conclusion on whether tax may be a good reason such as comparability with the rest of the group.

UK.2.1.23.1 In contrast, where the accounting frameworks of subsidiaries in a group are currently aligned, the burden of proof to justify departing from this situation is more onerous. The main purpose of having aligned accounting frameworks is to enable shareholders (amongst other interested parties) to understand the accounts and compare them with the accounts of other companies in the group. In considering whether there are good reasons to adopt different accounting frameworks, the directors must ask how obscure or difficult to understand different accounting frameworks would make the accounts in comparison to the rest of the group. Other factors include how certain it is that any tax planning arrangements put in place will lead to tax benefit, the size of any ensuing tax saving and reputational risk.

UK.2.1.24 Individual companies prepare either 'Companies Act individual financial statements' or 'IAS individual financial statements'. A group's consolidated financial statements are prepared as 'Companies Act consolidated financial statements' or 'IAS consolidated financial statements'. Schedules 1 and 6 of SI 2008/410, 'The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008', apply to 'Companies Act individual financial statements' and 'Companies Act consolidated financial statements' respectively. Those schedules do not apply to 'IAS individual financial statements' or 'IAS consolidated financial statements'. However, the basic requirement to prepare financial statements, including the circumstances in which consolidated financial statement are required, as well as the requirements on audit, approval, distribution and filing, continue to apply to all companies (see from para UK.2.1.38).

UK.2.1.25 Although the government has allowed a free choice for companies over IFRS adoption, within the limits described, there are other parties (such as regulators) that may force adoption or limit it.

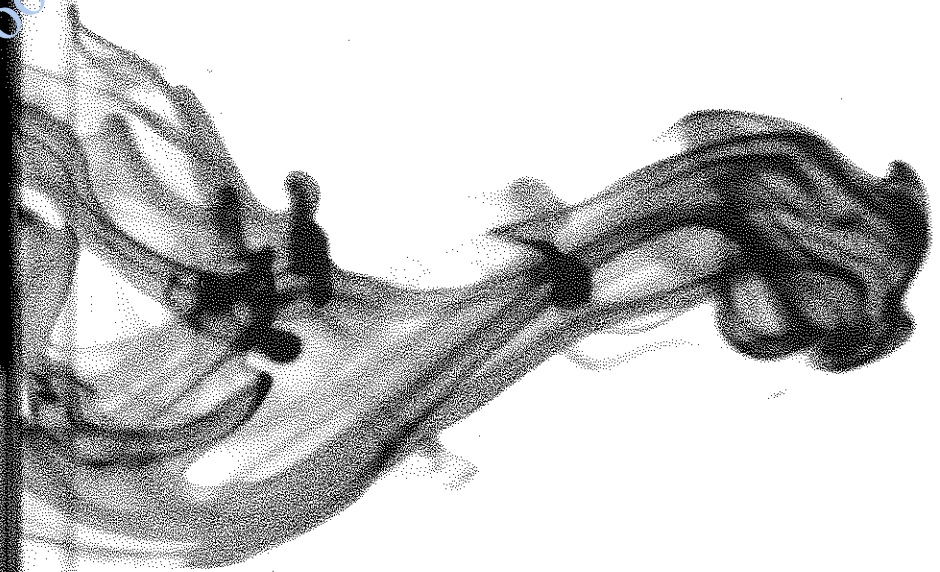
UK.2.1.26 The requirements and options to prepare financial statements under UK GAAP or IFRS are considered in the next section.

Manual of accounting

UK GAAP 2012

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Accounting principles and rules

The ASB's Statement of principles	2047
Objective	2048
The reporting entity	2048
Qualitative characteristics	2048
Materiality	2049
Elements	2050
Recognition	2051
Measurement	2052
Presentation	2052
Accounting for interests in other entities	2052

Chapter 2

Accounting principles and rules

Introduction

2.1 As discussed in chapter 1, the accounting framework in the UK is subject to a greater number of increasingly complicated rules. The sources of accounting principles and rules in the UK range from legislation and accounting standards to customs practised by professionals over many years. In addition, accounting under UK standards is increasingly influenced by practice overseas, for example, in the US and the IASB. International developments in particular are now a crucial source of UK GAAP: the UK ASB has accelerated its agenda of convergence with IFRS and, in 2009, the ASB issued a Consultation Paper proposing to replace existing UK GAAP with the new IFRS for small and medium entities. In October 2010, the UK ASB issued FRED 43 and 44 outlining the future for UK financial reporting. The proposals in FRED 43 and 44 recognise that one size of accounting standard does not fit all entities. It proposes a tier system for financial reporting that requires entities to prepare financial statements in one of three tiers. See further from paragraph 2.63.

2.2 This chapter explores the framework and sources of authority for the generally accepted accounting principles in the UK and how the Companies Act and accounting standards impact on the overriding requirement for financial statements to give a true and fair view.

[The next paragraph is 2.4.]

2.4 The ASB's convergence policy was prompted by the requirement for many companies to adopt IFRS in 2005. The EU approved a Regulation in June 2002 that requires all listed companies in the EU (including banks and insurance companies) to prepare their consolidated financial statements under EU-adopted IFRS ('IFRS') for financial years beginning on or after 1 January 2005. Member States had the option to extend this requirement to unlisted companies and to individual company financial statements. From 2005, any UK company (with the exception of charities) is permitted to prepare its financial statements using IFRS. It is, however, required that a consistent framework should be adopted within UK groups in most circumstances (see further para 2.22.5). Companies that do not choose to use IFRS will continue to prepare their financial statements under UK GAAP.

UK GAAP

The meaning and composition of UK GAAP

2.5 Generally Accepted Accounting Principles in the United Kingdom (UK GAAP) is a much-used, but undefined term. The components of UK GAAP vary according to the type of company or entity in question. However, in general terms, UK GAAP can be described as follows. The components are divided into elements that are mandatory (in law or in practice) and elements that are not mandatory. The core *mandatory* elements are:

- The Companies Act 2006.
- Accounting standards. That is:
 - Statements of Standard Accounting Practice (SSAPs) developed originally by the Accounting Standards Committee (ASC) and adopted in 1990 by the Accounting Standards Board (ASB).
 - Financial Reporting Standards (FRSs) issued by the ASB since 1990.
- Abstracts issued by the ASB's Urgent Issues Task Force (UITF).
- For listed companies, the Listing Rules.

2.6 Other elements of UK GAAP are authoritative to varying degrees but non-mandatory. These include:

- The ASB's Statement of principles for financial reporting. The Statement does not have the status of an accounting standard. Nevertheless, it is authoritative in two senses. First, the main purpose of the Statement of principles is to provide a frame of reference to guide the ASB in its development of standards. Therefore, it should be helpful in guiding companies and auditors as to the meaning and intention of individual accounting standards, if they are not clear. Secondly, the Statement is intended to provide a valuable source of reference in connection with the accounting treatment of transactions for which there is no specific GAAP.
- Other statements issued by the ASB. These include:
 - 'Half-yearly financial reports' — this was published as a non-mandatory document, but compliance with it was encouraged.
 - 'Preliminary announcements' — the ASB's guidance on preliminary announcements has been issued as a non-mandatory statement.
 - 'Operating and financial review' — in January 2006, the ASB published a best practice reporting statement on the operating and financial review (OFR), which builds on the ASB's previous 2003 statement of best practice on the OFR. See further chapter 2 in the Manual of Accounting — IFRS and UK Supplement.

- Statements and recommendations from the professional bodies. Examples are ICAEW Technical Releases (previously called 'FRAGs') such as Tech 02/10, 'Guidance on the determination of realised profits and losses in the context of distributions under the Companies Act 2006', and ICAEW accounting recommendations such as the members' handbook statements on materiality and 'Accounting for goods sold subject to reservation of title'.
- Established practice. Quite literally, practices that are generally accepted, even though not codified in official literature, can be regarded as part of UK GAAP. Much of this practice is set out in the guidance from leading accounting firms, such as in this Manual.

2.7 A key question is whether the output of the Financial Reporting Review Panel (FRRP) constitutes part of UK GAAP. The practical answer to the question is that it does. As discussed from paragraph 2.85, the FRRP does not issue rules, but announces its findings in relation to individual companies. In general, the companies in question have changed their accounting practices or given additional disclosure, following discussion with the Panel. The Panel generally issues formal statements only where it has concluded that companies have deviated from existing requirements of the Act or accounting standards. However, in some cases, the Panel's views have added to, or modified, the previous understanding of UK GAAP. For example, the Review Panel's press release on the financial statements of Trafalgar House led to the UITF issuing an Abstract on accounting for transfers from current assets to fixed assets. Consequently, companies and auditors should pay particular heed to the announcements from the Panel.

2.8 In addition, there are elements of UK GAAP that relate to specific sectors. Examples are the accounting requirements contained in legislation for banks, housing associations, and charities. Some sector-specific guidance is non-mandatory, and much of this appears in the form of Statements of recommended practice (SORPs), which are discussed from paragraph 2.74.

2.9 The Companies Act 2006 does not define the term 'generally accepted accounting principles', but makes reference in section 853(4) (definition of realised profits and realised losses). In addition, the Companies Act 2006 includes a requirement for companies to state whether the financial statements have been prepared in accordance with applicable Accounting standards and to give particulars of any material departures and the reasons for them (see also from para 2.41). [SI 2008/410 1 Sch 45].

[The next paragraph is 2.21.]

The Companies Act 2006

2.21 Although many detailed accounting rules have been added to companies legislation in recent years, its most important accounting requirements are, perhaps unsurprisingly, those that have been there longest (although not in

exactly the same words), namely the requirement for companies to prepare financial statements and the true and fair requirement.

The requirement to prepare financial statements

2.22 The directors are required to prepare financial statements for the company for each financial year that are in compliance with section 395 of the Companies Act 2006. These financial statements may be 'Companies Act individual financial statements' or 'IAS individual financial statements'. Companies Act individual financial statements must comprise a balance sheet as at the last day of the financial year and a profit and loss account for the financial year. [CA06 Sec 396]. The balance sheet must give a true and fair view of the company's state of affairs as at the end of the financial year; and the profit and loss account must give a true and fair view of the company's profit or loss for the financial year. In addition, the financial statements must comply with the provision made by the Secretary of State by regulations as to form and content and additional information provided by way of notes to the financial statements. [CA06 Sec 396(3)].

2.22.1 Companies preparing IAS individual financial statements are simply required to prepare financial statements in accordance with international accounting standards (and to state that they have done so in the note to the financial statements). [CA06 Sec 397]. 'International accounting standards' means IFRS as endorsed by the EU. [CA06 Sec 474]. The general rules and formats, accounting principles and disclosure requirements as outlined in Schedule 1 to SI 2008/410 do not apply to IAS individual financial statements. Financial statements prepared under EU-adopted IFRS are dealt with in the Manual of Accounting — IFRS for the UK.

2.22.2 In addition, if, at the end of the financial year, the company is a parent company within the meaning of the Companies Act 2006, the directors must also prepare consolidated financial statements for the group for the year, unless the company is exempt from that requirement. [CA06 Sec 399(2)].

2.22.3 Companies required to prepare consolidated financial statements under the Act that have any security listed on a regulated market within the EU are required to prepare those consolidated financial statements under EU-adopted IFRS (see para 2.4). These financial statements will be 'IFRS consolidated financial statements'. Companies that are not required to prepare consolidated IFRS financial statements may choose to do so. These financial statements will also be prepared in accordance with EU-adopted IFRS. Where the directors of a parent company prepare IFRS consolidated financial statements, they must state in the notes that the financial statements have been prepared in accordance with international accounting standards. [CA06 Sec 406].

2.22.4 Companies that are parent companies and that do not prepare IFRS consolidated financial statements are required to prepare 'Companies Act consolidated financial statements'. Such financial statements must give a true and fair view of the state of affairs at the end of the financial year and of the profit

or loss for the financial year of the undertakings included in the consolidation as a whole, so far as concerns the parent company's members and should consist of a consolidated balance sheet dealing with the state of affairs of the parent company and its subsidiaries as at the last date of the financial year and a profit and loss account for the financial year. In addition, the financial statements must comply with the provision made by the Secretary of State by regulations as to form and content and additional information provided by way of notes to the financial statements. [CA06 Sec 404(3)]. The exemptions from the requirement to prepare consolidated financial statements provided in the Act are discussed in chapter 24.

2.22.5 In most cases, companies have a free choice for financial years beginning on or after 1 January 2005 as to whether they prepare their *individual* financial statements under EU-adopted IFRS or under UK GAAP. Similarly, UK companies whose securities are not traded on a regulated market may prepare their *consolidated* financial statements under EU-adopted IFRS or under UK GAAP. However, the government has implemented some restrictions and conditions:

- Once a company has prepared its financial statements under EU-adopted IFRS, it cannot revert to UK GAAP in a later financial year, unless there is a "relevant change in circumstance". A relevant change in circumstance occurs if the company becomes a subsidiary of an undertaking that is not preparing its individual financial statements under EU-adopted IFRS; if the company ceases to be a subsidiary undertaking; or if the company (or its parent) ceases to have its securities admitted to trading on a regulated market in an EEA state. [CA06 Sec 395(3)(4)].
- A parent company may elect to prepare its individual financial statements under UK GAAP even if it elects to use EU-adopted IFRS in its consolidated financial statements.
- Where the parent company prepares group accounts, companies in the same group must adopt the same accounting framework as each other, unless there are "good reasons" not to do so. That is, the parent must ensure that all UK companies in the group use either EU-adopted IFRS or UK GAAP. There is an exception to this requirement: where a parent adopts EU-adopted IFRS in both its consolidated financial statements and its individual financial statements, it will not be required to ensure that all its subsidiaries use EU-adopted IFRS too. [CA06 Sec 407]. The Department of Business, Innovation and Skills ('BIS') (formerly the DTI and the BERR) has issued guidance notes on these rules, including an explanation of when there might be 'good reasons' (see para 2.22.6 below).
- Building societies are subject to the same requirements as companies in that they have the option of adopting IFRS in their individual and consolidated financial statements.
- Charitable companies may not prepare financial statements under IFRS. IFRS does not specifically address charity sector transactions and the government believes that the direct application of IFRS without

modification through a SORP might create 'interpretational issues'. In addition, there are no plans to permit unincorporated charities to use IFRS; adoption of IFRS by charitable corporations would, therefore, lead to inconsistency within the charity sector.

2.22.6 The BIS has issued guidance notes to help companies to apply these rules and these include an explanation of where there might be 'good reasons' for the directors not to prepare all the individual financial statements within a group by using the same accounting framework. The provision is intended to allow a degree of flexibility where there are genuine, including cost/benefit, grounds for not using the same framework. Such reasons would include:

- An IFRS group acquires a subsidiary that does not use IFRS. In the year of acquisition, it might not be practicable for the newly-acquired subsidiary to switch to IFRS straight away.
- A group might include subsidiaries that are themselves publicly traded, in which case market pressures or regulatory requirements to use IFRS might come into play, without necessarily justifying a switch to IFRS by the non-publicly traded subsidiaries.
- Where a subsidiary or a parent is planning to list and so might wish to convert to IFRS in advance, but the rest of the group is not intending to list.
- The group might include small subsidiaries where the cost of switching the accounting framework might outweigh the benefits from doing so.

It is essential that if the parent's directors decide to adopt a different framework for any entities within the group that they are able to justify any inconsistency to shareholders, regulators or other interested parties. [BIS Guidance para 4.16].

2.22.7 The BIS guidance notes do not make any specific mention of tax as a 'good reason' for adopting a different framework for one or more subsidiaries within a group. In commercial terms, tax is a business cost like any other. We have sought advice from legal counsel as to whether tax may be a good reason. The question is one of degree, depends on individual facts and circumstances, and the directors must weigh up various matters in reaching their conclusion.

2.22.7.1 In the case of existing arrangements or structures, where a transition from UK GAAP to EU-adopted IFRS would result in a significant increase or potential volatility in taxable profits, or a significant acceleration of tax cash outflows, or introduce a significant new tax exposure compared with the company continuing to use UK GAAP, the tax consequences may well be a 'good reason' to keep one or more subsidiaries on UK GAAP. For example, a company's revenue recognition might be accelerated under IFRS and thus tax payments might also be accelerated. In this context, 'significant' might be in absolute terms or relative to the size of the company affected. However, a trivial tax effect should not be used as an excuse to keep a company on UK GAAP. Similarly if as a result of a company using EU-adopted IFRS the group could no longer claim the benefits of existing tax planning (or the benefits would be significantly reduced or

new tax risks would arise under EU-adopted IFRS such that the planning would not have been entered into with companies using EU-adopted IFRS), the tax effect of using EU-adopted IFRS may be a good reason for one or subsidiaries to remain on UK GAAP. However, as noted above, it is also necessary to weigh up other matters in reaching the conclusion on whether tax may be a good reason, such as comparability with the rest of the group.

2.22.7.2 In contrast, where the accounting frameworks of subsidiaries in a group are currently aligned, the burden of proof to justify departing from this situation is more onerous. The main purpose of having aligned accounting frameworks is to enable shareholders (among other interested parties) to understand the accounts and compare them with the accounts of other companies in the group. In considering whether there are good reasons to adopt different accounting frameworks, the directors must ask how obscure or difficult to understand different accounting frameworks would make the accounts in comparison to the rest of the group. Other factors include how certain it is that any tax planning arrangements put in place will lead to tax benefit, the size of any ensuing tax saving and reputational risk.

2.22.8 Further guidance on which companies are required to use IFRS and which companies may optionally use it is given in chapter 2 of the Manual of Accounting — IFRS for the UK.

The true and fair requirement

2.23 In relation to Companies Act individual accounts, in addition to requiring companies to prepare accounts, the Companies Act 2006 section 396 specifies that the financial statements must:

- "in the case of the balance sheet, give a true and fair view of the state of affairs of the company as at the end of the financial year; and, in the case of the profit and loss account, give a true and fair view of the profit or loss of the company for the financial year." [CA06 Sec 396(2)].
- "...comply with provision made by the Secretary of State by regulations as to the form and content of the balance sheet and profit and loss account and additional information to be provided by way of notes to the accounts." [CA06 Sec 396(3)].

2.24 In most cases, companies are able to comply with both of these sub-sections at the same time. That is, compliance with the provisions made by the Secretary of State is consistent with the requirement to give a true and fair view.

2.25 However, this will not always be the case. The Act makes clear that the true and fair requirement is overriding, and sets this out in the following way:

- The Companies Act 2006 section 396(4) provides that:

"If compliance with the regulations and any other provision made by or under this Act as to the matters to be included in a company's individual accounts or in notes to those accounts, would not be sufficient to give a true and fair view, the necessary additional information must be given in the accounts or in a note to them."

■ The Companies Act 2006 section 396(5) adds that:

"If in special circumstances compliance with any of those provisions is inconsistent with the requirement to give a true and fair view, the directors must depart from that provision to the extent necessary to give a true and fair view."

■ The Companies Act 2006 section 396(5) notes that:

"Particulars of any such departure, the reasons for it and its effect must be given in a note to the accounts."

[The next paragraph is 2.27.]

2.27 Section 396(4) of the Companies Act 2006 can be seen as saying merely that compliance with the specific requirements of regulation and other parts of the Act is the minimum requirement. There may be a number of situations in which additional information has to be given, for example, to explain a somewhat unusual transaction. Without that explanation, the financial statements could not be said to give a true and fair view; but with the explanation added they do. Adding the information is the obvious solution and there is no need to consider departing from the specific rules. An example might be that, in order to give a true and fair view, it might be necessary to give information about a transaction with a related party.

2.28 Section 396(5), on the other hand, comes into operation when, owing to 'special circumstances', the accounting treatment otherwise required by the Act does not give a true and fair view, that is, if the treatment otherwise required by the Act (even with the provision of additional information) is inconsistent with a true and fair view.

2.29 Sub-sections 396(4) and 396(5) can, therefore, be seen not so much as sequential provisions, but as alternative provisions to assist in achieving a true and fair view. Each has a role in its own circumstances: sub-section 396(4) of the Companies Act 2006 comes into play where there is *insufficient* information; sub-section 396(5) of the Companies Act 2006 comes into play where there is the *wrong kind* of accounting treatment.

2.30 Although the notion of departing from the otherwise specific rules in order to give a true and fair view is a powerful and important one, that does not mean it is something that should be done frequently or cavalierly. Indeed, it is a treatment to be adopted sparingly. As sub-section 396(5) makes clear, it is only to be used 'in

special circumstances'. This means that it is not intended to be used as a route through which all companies can disregard a specific rule of the Act.

2.31 With few exceptions, such as SSAP19 (where companies are required to value investment properties rather than depreciate them, which is what the Act requires), the general understanding is that the override should only be used in the special circumstances of an individual company that has a different situation from most other companies. In practice, this can be extended to a class of companies, for example, in a particular industry, which has considerations that differ from the generality of companies. An example here is that in the past it has been regarded as acceptable for companies in the securities industry to use the override to 'mark to market' their current asset investments and take the resultant gains to the profit and loss account rather than, as the Act required, to the revaluation reserve. The reason it was acceptable for these types of companies is that, because of the nature of their businesses, this treatment gave a true and fair view of their performance, whereas the Act's treatment did not generally do so. However, other types of companies that adopted that practice had to demonstrate that they have special circumstances of their own. (The Act's rules have now been changed to permit fair value accounting for certain financial instruments — see further chapter 6.)

2.32 The majority of departures from the Act's accounting provisions in practice derive from requirements of accounting standards where the applicable accounting standard is inconsistent with the Act — for example, non-amortisation of goodwill with indefinite life (FRS 10).

2.33 Sub-section 396(5) requires certain disclosures to be given when the override is used. These disclosures are detailed in paragraph 2.42.

2.34 As discussed above, Companies Act consolidated financial statements are also required to give a true and fair view. [CA06 Sec 404(2)]. Sub-sections 404(4) and 404(5) contain identical provisions with respect to consolidated financial statements as sub-sections 396(4) and 396(5) respectively. Therefore, the discussion above applies equally to Companies Act consolidated financial statements.

Compliance with accounting standards and UITF abstracts

2.35 FRS 18, 'Accounting policies', recognises that the Act's requirement to give a true and fair view is paramount:

"An entity should adopt accounting policies that enable its financial statements to give a true and fair view. Those accounting policies should be consistent with the requirements of accounting standards, Urgent Issues Task Force (UITF) Abstracts and companies legislation." [FRS 18 para 14].

2.36 There is a general presumption that compliance with accounting standards is required to meet the true and fair requirement. The legal opinion supporting

this presumption is discussed from paragraph 2.78. In addition, paragraph 45 of Schedule 1 to SI 2008/410 requires companies to state in their financial statements whether they have been prepared in accordance with applicable accounting standards and to give the particulars and reasons for any material departures from those standards. Table 2.1 contains an example of a paragraph 45 statement.

Table 2.1 — Eleco plc — Annual report and financial statements — 30 June 2006

1 Accounting policies (extract)

The financial statements have been prepared in accordance with applicable accounting standards in the United Kingdom.

A summary of the more important Group accounting policies, which have been applied consistently, is set out below.

[The next paragraph is 2.38.]

2.38 While compliance with accounting standards and UITF Abstracts is usually required in order for financial statements to give a true and fair view, in exceptional circumstances a departure from an accounting standard or UITF Abstract may be necessary to meet the true and fair requirement. Where compliance with the requirements of an accounting standard or UITF Abstract is inconsistent with the requirement to give a true and fair view, FRS 18 requires a departure to the extent necessary to give a true and fair view. [FRS 18 para 15].

2.39 FRS 18's true and fair override in respect of accounting standards and UITF Abstracts is similar to the Act's true and fair override in respect of the Act's accounting provisions and applies to all types of entities whose financial statements are intended to give a true and fair view. Departures from accounting standards are, however, very rare indeed and should be handled with great care. The ASB's Foreword to Accounting Standards emphasises that compliance with accounting standards will normally be necessary to give a true and fair view because they are formulated with the objective of ensuring that the resulting financial information faithfully represents the underlying commercial activity.

2.40 FRS 18 explicitly provides a sequential approach to the true and fair override. First, entities need to consider what can be achieved by additional disclosure. A departure from an accounting standard is a last resort when a true and fair view cannot be achieved by additional disclosure. [FRS 18 para 16].

True and fair override disclosures

2.41 Where a company departs from any of the Act's accounting provisions in order to give a true and fair view, the Act requires that "...particulars of any such departure, the reasons for it and its effect shall be given in a note to the accounts". [CA06 Sec 396(5)].

2.42 The true and fair override disclosures required by FRS 18 give a more precise meaning to particulars, reasons and effect and bring together equivalent disclosures in respect of departures from the accounting provisions of the Companies Act or other relevant legislation, accounting standards and UITF Abstracts. The disclosures should include:

- A clear and unambiguous statement that there has been a departure from the requirements of an accounting standard, a UITF Abstract or companies legislation and that the departure is necessary to give a true and fair view.
- A statement of the treatment that would normally be required in the circumstances and a description of the treatment actually adopted.
- A statement as to why the treatment prescribed would not give a true and fair view.
- A description of how the position shown in the financial statements is different as a result of the departure, normally with quantification of the difference (except where quantification is self-evident or cannot reasonably be made, in which latter case the circumstances should be explained).

[FRS 18 para 62]

2.43 The disclosures referred to in the previous paragraph should be given considerable prominence. They should either be included in the note that discloses compliance with applicable accounting standards under paragraph 45 of Schedule 1 to SI 2008/410, or that note should include a cross reference to where such disclosures can be found. [FRS 18 para 64]. As explained earlier, the most common uses of the 'true and fair override' are overrides of company law that are required by accounting standards. In these cases, the applicable accounting standards have of course been complied with.

2.44 It should be noted that the fact that quantification of the effect may be regarded as misleading or meaningless is not, under FRS 18 or the Act, an acceptable reason for omitting it. To give an example of an override that cannot reasonably be quantified, it is not normally possible to quantify the effect of departing from the Companies Act where goodwill on an acquisition is not amortised — by ascribing an indefinite life (as permitted by FRS 10 in special circumstances), there is no benchmark for calculating an amortisation charge required by the Act.

The UK financial reporting structure

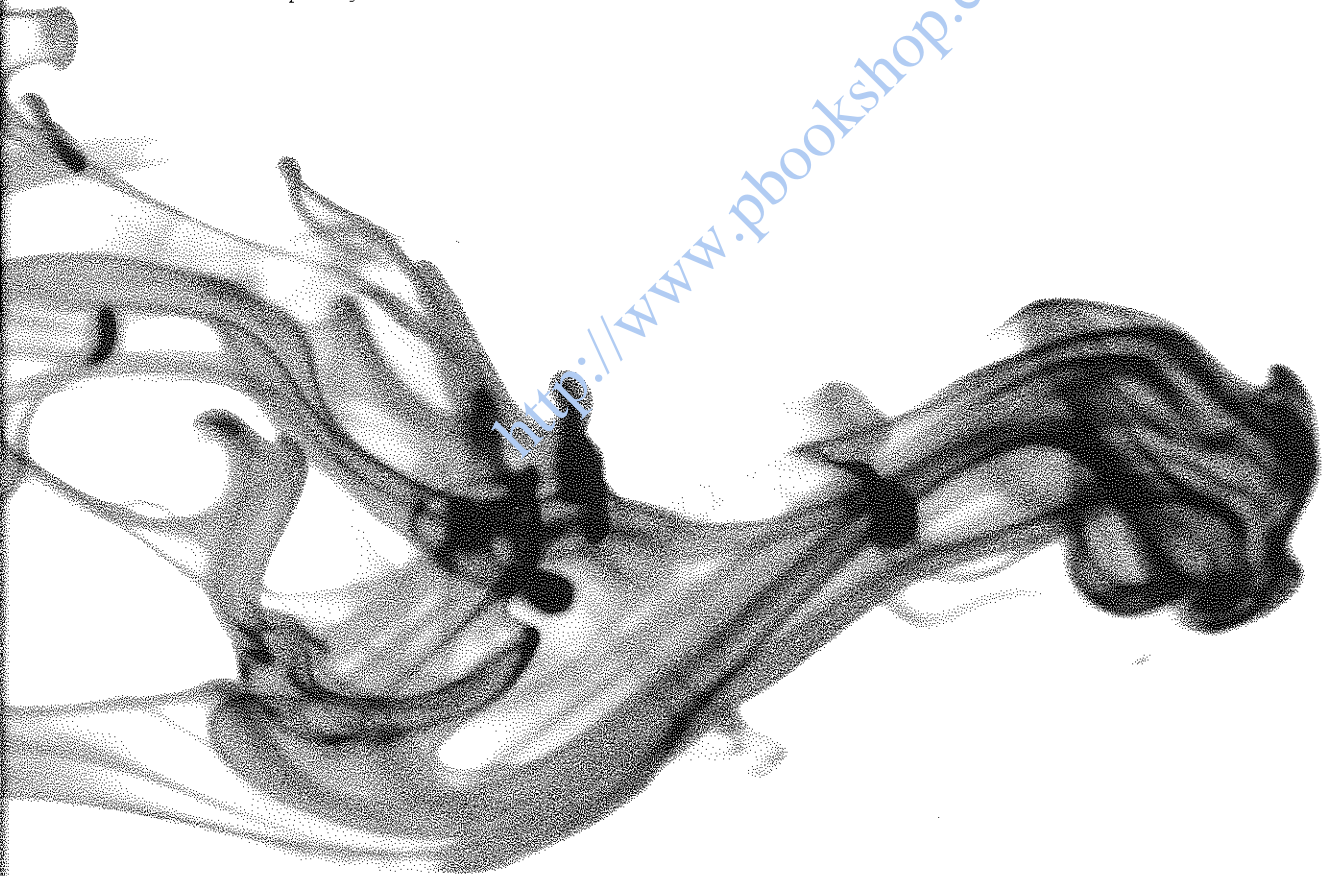
2.45 In the UK, the detail of accounting standards remains outside of legislation. However, UK legislation includes certain relevant requirements:

- For all large companies, directors are required to state in the notes to the financial statements whether they are drawn up in accordance with

*UK illustrative
financial statements*
for 2011 year ends

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Contents

	Page
Operating and financial review	1
Directors' report	6
Remuneration report	11
Corporate governance	22
Statement of directors' responsibilities	33
Independent auditors' report to the members of IFRS GAAP plc	35
Financial statements	37
Notes to the consolidated financial statements:	
1 General information	51
2 Summary of significant accounting policies:	51
2.1 Basis of preparation	52
2.2 Consolidation	53
2.3 Segment reporting	53
2.4 Foreign currency translation	53
2.5 Property, plant and equipment	54
2.6 Intangible assets	54
2.7 Impairment of non-financial assets	55
2.8 Non-current assets (or disposal groups) held for sale	55
2.9 Financial assets	55
2.10 Offsetting financial instruments	56
2.11 Impairment of financial assets	56
2.12 Derivative financial instruments and hedging activities	57
2.13 Inventories	58
2.14 Trade receivables	58
2.15 Cash and cash equivalents	58
2.16 Share capital	58
2.17 Trade payables	58
2.18 Borrowings	58
2.19 Borrowing costs	59
2.20 Compound financial instruments	59
2.21 Current and deferred income tax	59
2.22 Employee benefits	59
2.23 Share-based payments	60
2.24 Provisions	61
2.25 Revenue recognition	61
2.26 Interest income	62
2.27 Dividend income	62
2.28 Leases	62
2.29 Dividend distribution	62
2.30 Exceptional items	62
3 Financial risk management	64
4 Critical accounting estimates and judgements	72
5 Segment information	74
6 Exceptional items	77
7 Other income	77
8 Other (losses)/gains – net	77
9a Expenses by nature	77
9b Auditor remuneration	78
10a Employee benefit expense	78
10b Average number of people employed	78
11 Finance income and costs	79
12a Investments in subsidiaries	79
12b Investments in associates	79
13 Income tax expense	80
14 Earnings per share	81
15 Net foreign exchange gains/(losses)	82
16 Property, plant and equipment	82
17 Intangible assets	84
18a Financial instruments by category	86
18b Credit quality of financial assets	88
19 Available-for-sale financial assets	88
20 Derivative financial instruments	89
21 Trade and other receivables	90
22 Inventories	92

23	Financial assets at fair value through profit or loss	92
24	Cash and cash equivalents	92
25	Non-current assets held for sale and discontinued operations	93
26	Share capital and premium	94
27	Share-based payments	94
28	Retained earnings	95
29	Other reserves	96
30	Trade and other payables	97
31	Borrowings	97
32	Deferred income tax	99
33	Retirement benefit obligations	100
34	Provisions for other liabilities and charges	104
35	Dividends per share	105
36	Cash generated from operations	105
37	Contingencies	106
38	Commitments	106
39	Business combinations	106
40	Transactions with non-controlling interests	108
41	Related-party transactions	109
42	Events after the reporting period	111
43	Principal subsidiaries and associates	113
Appendices		
	Appendix I – Alternative presentation	114
	Consolidated statement of cash flows – direct method	114
	Consolidated statement of comprehensive income – single statement, showing expenses by function	115
	Appendix II – Areas not illustrated in financial statements of IFRS GAAP Plc	117
	Biological assets	118
	Construction contracts	120
	Oil and gas exploration assets	121
	Financial guarantee contracts	123
	Leases: accounting by lessor	125
	Government grants	126
	Joint ventures	127
	Revenue recognition: multiple-element arrangements	127
	Customer loyalty programmes	128
	Put option arrangements	128
	Foreign currency translations	129
	Share-based payments	128
	Appendix III – New standards and amendments	129

(All amounts in £ thousands unless otherwise stated)

- (d) the date as at which it plans to apply it initially, and
 (e) either:
 (i) a discussion of the impact that initial application of the IFRS is expected to have on the entity's financial statements, or
 (ii) if that impact is not known or reasonably estimable, a statement to that effect.

11. Our view is that disclosures in the paragraph above are not necessary in respect of standards and interpretations that are clearly not applicable to the entity (for example industry-specific standards) or that are not expected to have a material effect on the entity. Instead, disclosure should be given in respect of the developments that are, or could be, significant to the entity. Management will need to apply judgement in determining whether a standard is expected to have a material effect. The assessment of materiality should consider the impact both on previous transactions and financial position and on reasonably foreseeable future transactions. For pronouncements where there is an option that could have an impact on the entity, the management expectation on whether the entity will use the option should be disclosed.

Disclosures not illustrated in IFRS GAAP plc financial statements

For disclosures relating to IAS 29, 'Financial reporting in hyperinflationary economies' and IFRS 6, 'Exploration for and evaluation of mineral resources', please refer to PwC's *IFRS disclosure checklist 2011*.

3 Financial risk management

Group

3.1 Financial risk factors

IFRS7p31 The group's activities expose it to a variety of financial risks: market risk (including currency risk, fair value interest rate risk, cash flow interest rate risk and price risk), credit risk and liquidity risk. The group's overall risk management programme focuses on the unpredictability of financial markets and seeks to minimise potential adverse effects on the group's financial performance. The group uses derivative financial instruments to hedge certain risk exposures.

Risk management is carried out by a central treasury department (group treasury) under policies approved by the board of directors. Group treasury identifies, evaluates and hedges financial risks in close co-operation with the group's operating units. The board provides written principles for overall risk management, as well as written policies covering specific areas, such as foreign exchange risk, interest rate risk, credit risk, use of derivative financial instruments and non-derivative financial instruments, and investment of excess liquidity.

(a) Market risk

(i) Foreign exchange risk

IFRS7 p33(a) The group operates internationally and is exposed to foreign exchange risk arising from various currency exposures, primarily with respect to the US dollar and the UK pound. Foreign exchange risk arises from future commercial transactions, recognised assets and liabilities and net investments in foreign operations.

IFRS7 p33(b), 22(c) Management has set up a policy to require group companies to manage their foreign exchange risk against their functional currency. The group companies are required to hedge their entire foreign exchange risk exposure with the group treasury. To manage their foreign exchange risk arising from future commercial transactions and recognised assets and liabilities, entities in the group use forward contracts, transacted with group treasury. Foreign exchange risk arises when future commercial transactions or recognised assets or liabilities are denominated in a currency that is not the entity's functional currency.

IFRS7 p22(c) The group treasury's risk management policy is to hedge between 75% and 100% of anticipated cash flows (mainly export sales and purchase of inventory) in each major foreign currency for the subsequent 12 months. Approximately 90% (2010: 95%) of projected sales in each major currency qualify as 'highly probable' forecast transactions for hedge accounting purposes.

**IFRS7 p33(a)(b)
IFRS7 p22(c)** The group has certain investments in foreign operations, whose net assets are exposed to foreign currency translation risk. Currency exposure arising from the net assets of the group's foreign operations is managed primarily through borrowings denominated in the relevant foreign currencies.

**IFRS7p40
IFRS7IG36** At 31 December 2011, if the currency had weakened/strengthened by 11% against the US dollar with all other variables held constant, post-tax profit for the year would have been £362 (2010: £51) higher/lower, mainly as a result of foreign exchange gains/losses on translation of US dollar-denominated trade receivables, financial assets at fair value through profit or loss, debt securities classified as available-for-sale and foreign exchange losses/gains on translation of US dollar-denominated borrowings. Profit is more sensitive to movement in currency/US dollar exchange rates in 2011 than 2010 because of the increased amount of US dollar-denominated borrowings. Similarly, the impact on equity would have been £6,850 (2010: £6,650) higher/ lower due to an increase in the volume of cash flow hedging in US dollars.

(All amounts in C thousands unless otherwise stated)

At 31 December 2011, if the currency had weakened/strengthened by 4% against the UK pound with all other variables held constant, post-tax profit for the year would have been C135 (2010: C172) lower/higher, mainly as a result of foreign exchange gains/losses on translation of UK pound-denominated trade receivables, financial assets at fair value through profit or loss, debt securities classified as available-for-sale and foreign exchange losses/gains on translation of UK pound-denominated borrowings.

(ii) Price risk

IFRS7
p33(a)(b)

The group is exposed to equity securities price risk because of investments held by the group and classified on the consolidated balance sheet either as available-for-sale or at fair value through profit or loss. The group is not exposed to commodity price risk. To manage its price risk arising from investments in equity securities, the group diversifies its portfolio. Diversification of the portfolio is done in accordance with the limits set by the group.

The group's investments in equity of other entities that are publicly traded are included in one of the following three equity indexes: DAX equity index, Dow Jones equity index and FTSE 100 UK equity index.

IFRS7p40
IFRS7IG36

The table below summarises the impact of increases/decreases of the three equity indexes on the group's post-tax profit for the year and on equity. The analysis is based on the assumption that the equity indexes had increased/decreased by 5% with all other variables held constant and all the group's equity instruments moved according to the historical correlation with the index:

Index	Impact on post-tax profit in C		Impact on other components of equity in C	
	2011	2010	2011	2010
DAX	200	120	290	290
Dow Jones	150	120	200	70
FTSE 100 UK	60	30	160	150

Post-tax profit for the year would increase/decrease as a result of gains/losses on equity securities classified as at fair value through profit or loss. Other components of equity would increase/ decrease as a result of gains/losses on equity securities classified as available for sale.

(iii) Cash flow and fair value interest rate risk

IFRS7p33
(a)(b).
IFRSp22(c)

The group's interest rate risk arises from long-term borrowings. Borrowings issued at variable rates expose the group to cash flow interest rate risk which is partially offset by cash held at variable rates. Borrowings issued at fixed rates expose the group to fair value interest rate risk. Group policy is to maintain approximately 60% of its borrowings in fixed rate instruments. During 2011 and 2010, the group's borrowings at variable rate were denominated in the Currency and the UK pound.

IFRS7p22(b)(c) The group analyses its interest rate exposure on a dynamic basis. Various scenarios are simulated taking into consideration refinancing, renewal of existing positions, alternative financing and hedging. Based on these scenarios, the group calculates the impact on profit and loss of a defined interest rate shift. For each simulation, the same interest rate shift is used for all currencies. The scenarios are run only for liabilities that represent the major interest-bearing positions.

Based on the simulations performed, the impact on post tax profit of a 0.1% shift would be a maximum increase of C41 (2010: C37) or decrease of C34 (2010: C29), respectively. The simulation is done on a quarterly basis to verify that the maximum loss potential is within the limit given by the management.

IFRS7p22(b)(c) Based on the various scenarios, the group manages its cash flow interest rate risk by using floating-to-fixed interest rate swaps. Such interest rate swaps have the economic effect of converting borrowings from floating rates to fixed rates. Generally, the group raises long-term borrowings at floating rates and swaps them into fixed rates that are lower than those available if the group borrowed at fixed rates directly. Under the interest rate swaps, the group agrees with other parties to exchange, at specified intervals (primarily quarterly), the difference between fixed contract rates and floating-rate interest amounts calculated by reference to the agreed notional amounts.

IFRS7p22(b)(c) Occasionally the group also enters into fixed-to-floating interest rate swaps to hedge the fair value interest rate risk arising where it has borrowed at fixed rates in excess of the 60% target.

IFRS7p40
IFRS7IG36

At 31 December 2011, if interest rates on Currency-denominated borrowings had been 10 basis points higher/lower with all other variables held constant, post-tax profit for the year would have been C22 (2010: C21) lower/higher, mainly as a result of higher/lower interest expense on floating rate borrowings; other components of equity would have been C5 (2010: C3) lower/ higher mainly as a result of a decrease/increase in the fair value of fixed rate financial assets classified as available for sale. At 31 December 2011, if interest rates on UK pound-denominated borrowings at that date had been 0.5% higher/lower with all other variables held constant, post-tax profit for the year would have been C57 (2010: C38) lower/higher, mainly as a result of higher/lower interest expense on floating rate borrowings; other components of equity would have been C6 (2010: C4) lower/higher mainly as a result of a decrease/increase in the fair value of fixed rate financial assets classified as available for sale.

(All amounts in C thousands unless otherwise stated)

(b) Credit risk

IFRS7p33(a)(b) Credit risk is managed on group basis, except for credit risk relating to accounts receivable balances. Each local entity is responsible for managing and analysing the credit risk for each of their new clients before standard payment and delivery terms and conditions are offered. Credit risk arises from cash and cash equivalents, derivative financial instruments and deposits with banks and financial institutions, as well as credit exposures to wholesale and retail customers, including outstanding receivables and committed transactions. For banks and financial institutions, only independently rated parties with a minimum rating of 'A' are accepted. If wholesale customers are independently rated, these ratings are used. If there is no independent rating, risk control assesses the credit quality of the customer, taking into account its financial position, past experience and other factors. Individual risk limits are set based on internal or external ratings in accordance with limits set by the board. The utilisation of credit limits is regularly monitored. Sales to retail customers are settled in cash or using major credit cards. See note 9(b) for further disclosure on credit risk.

No credit limits were exceeded during the reporting period, and management does not expect any losses from non-performance by these counterparties.

(c) Liquidity risk

IFRS7 p33(a),(b) 34(a) Cash flow forecasting is performed in the operating entities of the group in and aggregated by group finance. Group finance monitors rolling forecasts of the group's liquidity requirements to ensure it has sufficient cash to meet operational needs while maintaining sufficient headroom on its undrawn committed borrowing facilities (note 22) at all times so that the group does not breach borrowing limits or covenants (where applicable) on any of its borrowing facilities. Such forecasting takes into consideration the group's debt financing plans, covenant compliance, compliance with internal balance sheet ratio targets and, if applicable external regulatory or legal requirements – for example, currency restrictions.

IFRS7 p33(a),(b) 39(c) IFRS7B11E Surplus cash held by the operating entities over and above balance required for working capital management are transferred to the group treasury. Group treasury invests surplus cash in interest bearing current accounts, time deposits, money market deposits and marketable securities, choosing instruments with appropriate maturities or sufficient liquidity to provide sufficient head-room as determined by the above-mentioned forecasts. At the reporting date, the group held money market funds of C6, 312 (2010: C934) and other liquid assets of C321 (2010: C1, 400) that are expected to readily generate cash inflows for managing liquidity risk.

IFRS7p39(a)(b) The table below analyses the group's non-derivative financial liabilities and net-settled derivative financial liabilities into relevant maturity groupings based on the remaining period at the balance sheet date to the contractual maturity date. Derivative financial liabilities are included in the analysis if their contractual maturities are essential for an understanding of the timing of the cash flows. The amounts disclosed in the table are the contractual undiscounted cash flows¹.

At 31 December 2011	Less than 3 months	Between 3 months and 1 year ²	Between 1 and 2 years ²	Between 2 and 5 years ²	Over 5 years ²
Borrowings (ex finance lease liabilities)	5,112	15,384	22,002	67,457	38,050
Finance lease liabilities	639	2,110	1,573	4,719	2,063
Trading and net settled derivative financial instruments (interest rate swaps)	280	–	10	116	41
Trade and other payables	12,543	3,125 ²	–	–	–
Financial guarantee contracts	21	–	–	–	–
At 31 December 2010					
Borrowings (ex finance lease liability)	4,061	12,197	11,575	58,679	38,103
Finance lease liabilities	697	2,506	1,790	5,370	2,891
Trading and net settled derivative financial instruments (interest rate swaps)	317	–	15	81	50
Trade and other payables	9,214	2,304 ³	–	–	–
Financial guarantee contracts	10	–	–	–	–

IFRS7 B10A(a) Of the C67,457 disclosed in the 2011 borrowings time band 'Between 2 and 5 years' the company intends to repay C40,000 in the first quarter of 2011 (2010: nil).

IFRS7p39(b) The group's trading portfolio derivative instruments with a negative fair value have been included at their fair value of C268 (2010: C298) within the less than three month time bucket. This is because the contractual maturities are not

¹ IFRS7 p39(a)(b) The amounts included in the table are the contractual undiscounted cash flows, except for trading derivatives, which are included at their fair value (see below). As a result, these amounts will not reconcile to the amounts disclosed on the balance sheet except for short-term payables where discounting is not applied. Entities can choose to add a reconciling column and a final total that ties into the balance sheet, if they wish.

² The specific time-buckets presented are not mandated by the standard but are based on a choice by management based on how the business is managed. Sufficient time buckets should be provided to give sufficient granularity to provide the reader with an understanding of the entity's liquidity.

³ The maturity analysis applies to financial instruments only; non-financial liabilities are not therefore included.

(All amounts in C thousands unless otherwise stated)

essential for an understanding of the timing of the cash flows. These contracts are managed on a net-fair value basis rather than by maturity date. Net settled derivatives comprise interest rate swaps used by the group to manage the group's interest rate profile.

IFRS7p39(b) All of the non-trading group's gross settled derivative financial instruments are in hedge relationships and are due to settle within 12 months of the balance sheet date. These contracts require undiscounted contractual cash inflows of C78,756 (2010: C83,077) and undiscounted contractual cash outflows of C78,241 (2010: C83,366).

1p134,135, IG10 **3.2 Capital management**

The group's objectives when managing capital are to safeguard the group's ability to continue as a going concern in order to provide returns for shareholders and benefits for other stakeholders and to maintain an optimal capital structure to reduce the cost of capital.

In order to maintain or adjust the capital structure, the group may adjust the amount of dividends paid to shareholders, return capital to shareholders, issue new shares or sell assets to reduce debt.

Consistent with others in the industry, the group monitors capital on the basis of the gearing ratio. This ratio is calculated as net debt divided by total capital. Net debt is calculated as total borrowings (including 'current and non-current borrowings' as shown in the consolidated balance sheet) less cash and cash equivalents. Total capital is calculated as 'equity' as shown in the consolidated balance sheet plus net debt.

During 2011, the group's strategy, which was unchanged from 2010, was to maintain the gearing ratio within 45% to 50% and a BB credit rating. The BB credit rating has been maintained throughout the period. The gearing ratios at 31 December 2011 and 2010 were as follows:

	2011	2010
Total borrowings (note 22)	126,837	114,604
Less: cash and cash equivalents (note 15)	(17,928)	(34,062)
Net debt	108,909	80,542
Total equity	131,773	88,946
Total capital	240,682	169,488
Gearing ratio	45%	48%

The decrease in the gearing ratio during 2011 resulted primarily from the issue of share capital as part of the consideration for the acquisition of a subsidiary (notes 17 and 39).

3.3 Fair value estimation

The table below analyses financial instruments carried at fair value, by valuation method. The different levels have been defined as follows:

- Quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1).
- Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (that is, as prices) or indirectly (that is, derived from prices) (Level 2).
- Inputs for the asset or liability that are not based on observable market data (that is, unobservable inputs) (Level 3).

IFRS7 p27B(a)

The following table presents the group's assets and liabilities that are measured at fair value at 31 December 2011.

	Level 1	Level 2	Level 3	Total
Assets				
Financial assets at fair value through profit or loss				
– Trading derivatives	–	250	111	361
– Trading securities	11,820	–	–	11,820
Derivatives used for hedging	–	1,103	–	1,103
Available-for-sale financial assets				
– Equity securities	18,735	–	–	18,735
– Debt investments	288	347	–	635
Total assets	30,843	1,700	111	32,654
Liabilities				
Financial liabilities at fair value through profit or loss				
– Trading derivatives	–	268	–	268
Derivatives used for hedging	–	327	–	327
Total liabilities	–	595	–	595

(All amounts in £ thousands unless otherwise stated)

The following table presents the group's assets and liabilities that are measured at fair value at 31 December 2010.

	Level 1	Level 2	Level 3	Total
Assets				
Financial assets at fair value through profit or loss:				
- Trading derivatives	-	321	-	321
- Trading securities	7,972	-	-	7,972
Derivatives used for hedging	-	875	-	875
Available-for-sale financial assets:				
- Equity securities	14,646	-	-	14,646
- Debt investments	-	264	-	264
Total assets	22,618	1,460		24,078
Liabilities				
Financial liabilities at fair value through profit or loss:				
- Trading derivatives	-	298	-	298
Derivatives used for hedging	-	449	-	449
Total liabilities		747		747

IFRS7p27

The fair value of financial instruments traded in active markets is based on quoted market prices at the balance sheet date. A market is regarded as active if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service, or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. The quoted market price used for financial assets held by the group is the current bid price. These instruments are included in Level 1. Instruments included in Level 1 comprise primarily DAX, FTSE 100 and Dow Jones equity investments classified as trading securities or available for sale.

The fair value of financial instruments that are not traded in an active market (for example, over-the-counter derivatives) is determined by using valuation techniques. These valuation techniques maximise the use of observable market data where it is available and rely as little as possible on entity specific estimates. If all significant inputs required to fair value an instrument are observable, the instrument is included in Level 2.

If one or more of the significant inputs is not based on observable market data, the instrument is included in Level 3.

Specific valuation techniques used to value financial instruments include:

- Quoted market prices or dealer quotes for similar instruments.
- The fair value of interest rate swaps is calculated as the present value of the estimated future cash flows based on observable yield curves.
- The fair value of forward foreign exchange contracts is determined using forward exchange rates at the balance sheet date, with the resulting value discounted back to present value.
- Other techniques, such as discounted cash flow analysis, are used to determine fair value for the remaining financial instruments.

Note that all of the resulting fair value estimates are included in Level 2 except for certain forward foreign exchange contracts explained below.

IFRS7p27B(c) The following table presents the changes in Level 3 instruments for the year ended 31 December 2011.

	Trading derivative's at fair value through profit or loss	Total
Opening balance	-	-
Transfers into Level 3	115	115
Gains and losses recognised in profit or loss	(4)	(4)
Closing balance	111	111
Total gains or losses for the period included in profit or loss for assets held at the end of the reporting period	(4)	(4)

(All amounts in C thousands unless otherwise stated)

The following table presents the changes in Level 3 instruments for the year ended 31 December 2010.

	Trading derivative's at fair value through profit or loss	Total
Opening balance	62	62
Settlements	(51)	(51)
Gains and losses recognised in profit or loss	(11)	(11)
Closing balance	-	-
Total gains or losses for the period included in profit or loss for assets held at the end of the reporting period	-	-

In 2011, the group transferred a held-for-trading forward foreign exchange contract from Level 2 into Level 3. This is because the counterparty for the derivative encountered significant financial difficulties, which resulted in a significant increase to the discount rate due to increased counterparty credit risk, which is not based on observable inputs.

if the change in the credit default rate would be shifted +/- 5% the impact on profit or loss would be C20.

IFRS7 p27B(e)

Commentary – financial risk management

Accounting standard for presentation and disclosure of financial instruments

IFRS7p3

1. IFRS 7, 'Financial Instruments: Disclosures', applies to all reporting entities and to all types of financial instruments except:

- Those interests in subsidiaries, associates and joint ventures that are accounted for under IAS 27, 'Consolidated and separate financial statements', IAS 28, 'Investments in associates', or IAS 31, 'Interests in joint ventures'. However, entities should apply IFRS 7 to an interest in a subsidiary, associate or joint venture that according to IAS 27, IAS 28 or IAS 31 is accounted for under IAS 39, 'Financial Instruments: Recognition and measurement'. Entities should also apply IFRS 7 to all derivatives on interests in subsidiaries, associates or joint ventures unless the derivative meets the definition of an equity instrument in IAS 32, 'Financial Instruments: Presentation'.
- Employers' rights and obligations under employee benefit plans, to which IAS 19, 'Employee benefits', applies.
- Insurance contracts as defined in IFRS 4, 'Insurance contracts'. However, IFRS 7 applies to derivatives that are embedded in insurance contracts if IAS 39 requires the entity to account for them separately. It also applies to financial guarantee contracts if the issuer applies IAS 39 in recognising and measuring the contracts.
- Financial instruments, contracts and obligations under share-based payment transactions to which IFRS 2, 'Share-based payments', applies, except for contracts within the scope of paragraphs 5-7 of IAS 39, which are disclosed under IFRS 7.
- Puttable financial instruments that are required to be classified as equity instruments in accordance with paragraphs 16A and 16B or 16C and 16D of IAS 32.

Parent entity disclosures

IFRS7

2. Where applicable, all disclosure requirements outlined in IFRS 7 should be made for both the parent and consolidated entity. The relief from making parent entity disclosures, which was previously available under IAS 30, 'Disclosures in the financial statements of banks and similar financial institutions', and IAS 32, has not been retained in IFRS 7.

Classes of financial instrument

IFRS7p6, B1-B3

3. Where IFRS 7 requires disclosures by class of financial instrument, the entity groups its financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. The entity should provide sufficient information to permit reconciliation to the line items presented in the balance sheet. Guidance on classes of financial instruments and the level of required disclosures is provided in appendix B of IFRS 7.

Level of detail and selection of assumptions – information through the eyes of management

IFRS7p34(a)

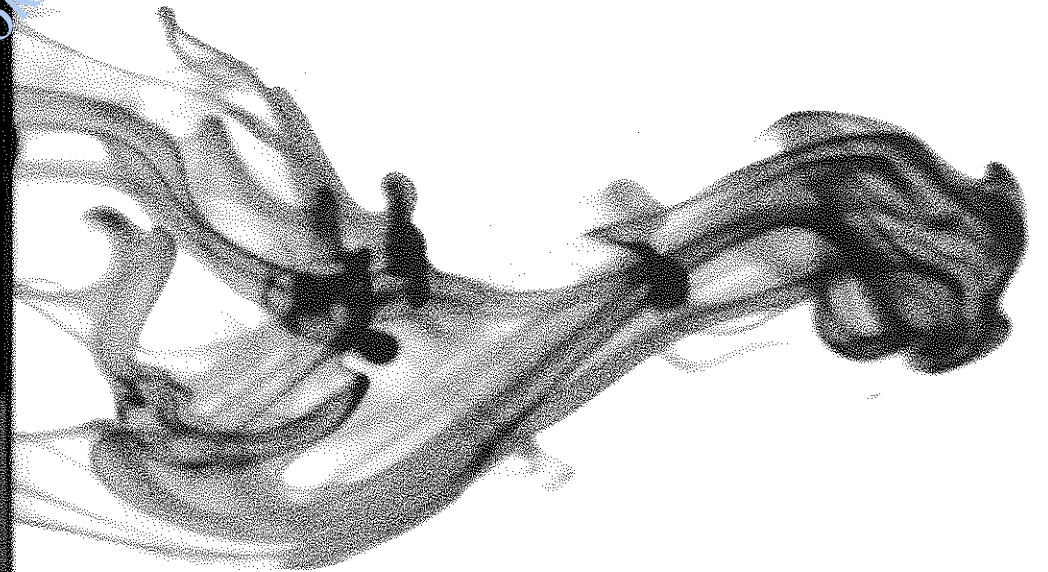
4. The disclosures in relation to an entity's financial risk management should reflect the information provided internally to key management personnel. As such, the disclosures that will be provided by an entity, their level of detail and the underlying assumptions used will vary greatly from entity to entity. The disclosures in this illustrative financial statement are only one example of the kind of information that may be disclosed; the entity should consider carefully what may be appropriate in its individual circumstances.

Manual of accounting

Financial instruments
2012

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Contents

	Page
<i>Abbreviations and terms used</i>	P011
Chapter	Page
1 Overview	1001
2 Introduction	2002
3 Objective and scope of IAS 32, IAS 39 and IFRS 7	3001
4 Nature and characteristics of financial instruments	4001
5 Embedded derivatives in host contracts	5001
6 Classification of financial instruments	6001
7 Financial liabilities and equity	7001
8 Recognition and derecognition	8001
9 Measurement of financial assets and liabilities	9001
10 Hedge accounting	10001
11 Presentation and disclosure	11001
12 IFRS 9, 'Financial instruments'	12001
Index	1001

Manual of Accounting – IFRS

This separate book is part of this Manual of Accounting and includes the following chapters.

Accounting rules and principles

1 Introduction	1001
2 Accounting principles and applicability of IFRS	2001
3 First-time adoption of IFRS	3001
4 Presentation of financial statements	4001
5 Accounting policies, accounting estimates and errors	5001
6 Hyper-inflation	6001
7 Foreign currencies	7001
8 Insurance contracts	8001

Income statement and related notes

9 Revenue and construction contracts	9001
10 Segment reporting	10001
11 Employee benefits	11001
11A Employee benefits	11A001
12 Share-based payment	12001
13 Taxation	13001
14 Earnings per share	14001

Abbreviations and terms used

VAT	value added tax
VIE	variable interest entity
WACC	weighted average cost of capital
WEEE	Waste electrical and electronic equipment
WLR	Weekly Law Reports
xBRL	extensible business reporting language

Chapter 1

Overview

	Page
Introduction.....	1001
Objectives and scope of IAS 32, IAS 39 and IFRS 7.....	1002
Nature and characteristics of financial instruments.....	1004
Embedded derivatives.....	1006
Classification of financial instruments.....	1006
Financial liabilities and equity.....	1008
Recognition and derecognition.....	1009
Measurement.....	1011
Hedge accounting.....	1013
Hedging instruments.....	1014
Hedge accounting criteria.....	1014
Hedge accounting rules.....	1014
Discontinuing hedge accounting.....	1016
Presentation and disclosure.....	1016

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Chapter 1

Overview

Introduction

1.1 Current requirements for financial instruments are included in IAS 32, 'Financial instruments: Presentation', IAS 39, 'Financial instruments: Recognition and measurement', IFRS 9, 'Financial instruments', IFRS 7, 'Financial instruments: Disclosures', and IFRS 13, 'Fair value measurement'.

1.2 To apply in the EU, IFRSs must be endorsed by an EU 'endorsement mechanism'. In November 2004, the European Commission adopted a 'carve-out' version of IAS 39, which deleted a limited number of words and paragraphs from IAS 39 relating to the use of the 'fair value option' for financial liabilities and certain aspects of hedge accounting. Since that time, the IASB has published an amendment to IAS 39 incorporating a revised 'fair value option' and this has been adopted for use within the EU. However, differences between the IASB's 'full IAS 39' and the EU's 'carve-out' version of the standard still remain. The IASB issued IFRS 9 in November 2009 and updated the standard in October 2010 for financial liabilities. The EU has not yet endorsed IFRS 9.

1.2.1 The Board intends that IFRS 9 will ultimately replace IAS 39 in its entirety. However, in response to requests from interested parties that the accounting for financial instruments should be improved quickly, the Board divided its project to replace IAS 39 into three main phases. The first phase, which is now completed, relates to the classification and measurement of financial assets and liabilities. The new requirements are discussed in chapter 12 of this publication and can be early adopted subject to EU endorsement. Proposals addressing the second phase relating to the impairment methodology for financial assets and proposals addressing the third phase relating to hedge accounting continue to be developed. IFRS 9 and IAS 39 will operate in tandem for some time, with entities selecting which one of the two to apply. IAS 32 and IFRS 7 will apply whichever regime is adopted, albeit with some adaptations. Additionally, the Board is addressing offsetting of financial assets and financial liabilities to replace the relevant part of IAS 32.

1.2.2 IFRS 13, 'Fair value measurement', was issued in May 2011 and has not yet been endorsed by the EU. Its scope extends to any item recognised in the financial statements at fair value and its application to financial instruments is discussed in chapter 34 of the IFRS Manual of Accounting.

Objectives and scope of IAS 32, IAS 39 and IFRS 7

1.3 IAS 32 establishes principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and liabilities. It applies to the classification of financial instruments into financial assets, financial liabilities and equity instruments from the issuer's perspective; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets and liabilities can be offset.

1.4 IAS 39 is an extremely long and complex standard that establishes principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. IAS 39 also deals with derecognition of financial assets and liabilities and hedge accounting.

1.5 IFRS 7 requires entities to provide disclosures that enable users to evaluate:

- the significance of financial instruments for the entity's financial position and performance; and
- the nature and extent of risks arising from financial instruments to which the entity is exposed and how the entity manages them.

1.6 The scope of the three standards is very wide ranging. The definition of a financial instrument under IFRS is "any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity". This definition encompasses cash, debt and equity investments, trade receivables and payables, debt, certain provisions, net cash-settled commodity contracts and derivatives (including embedded derivatives). However, certain financial instruments are excluded from the scope of one or all of the standards, as summarised in the table below.

Within scope of IAS 32, IAS 39 and IFRS 7	Within scope of IAS 32 and IFRS 7 only	Out of scope
Debt and equity investments		
Investments in subsidiaries, associates and joint ventures accounted for under IAS 39. Contingent consideration in a business combination that is a financial instrument (Note 1).	Any forward contract between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination at a future acquisition date (Note 2).	Investments in subsidiaries, associates and joint ventures accounted for under IAS 27, IAS 28 or IAS 31.
Loans and receivables	Lease receivables (Note 3)	
Gross amount due from customers for construction contract work		
Own debt	Lease payables (Note 3) Own equity	Employee benefits Share-based payments
Cash and cash equivalents		
Derivatives – for example:	Derivatives on own shares settled only by delivery of a fixed number of shares for a fixed amount of cash	Own use commodity contracts (Note 4)
■ Interest rate swaps		
■ Currency forwards/swaps		
■ Purchased/written options		
■ Commodity contracts (Note 4)		
■ Collars/caps		
■ Credit derivatives		
■ Cash or net share settleable derivatives on own shares		
Derivatives on subsidiaries, associates and joint ventures that do not meet the criteria of an equity instrument		
Embedded derivatives		
Weather derivatives		
Loan commitments held for trading (Note 5)	Other loan commitments	
Financial guarantees (Note 6)		Insurance contracts Contracts with discretionary participation features (Note 7)

Note 1 – IFRS 3 has removed the scope exemption for contingent consideration in a business combination. On adoption of IFRS 3 contingent consideration from both the acquiree and acquirer's perspective is in the scope of IAS 32, IAS 39 and IFRS 7.

Note 2 – The term of the forward contract should not exceed a reasonable period normally necessary to obtain any required approvals and to complete the transaction. Any forward contract between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination at a future acquisition date is within IFRS 7's scope.

Note 3 – Lease receivables are included in IAS 39's scope for derecognition and impairment purposes only. Finance lease payables are subject to the derecognition provisions. Any derivatives embedded in lease contracts are also within IAS 39's scope.

Note 4 – Contracts to buy or sell non-financial items are within IAS 32's scope, IAS 39 and IFRS 7 if they can be settled net in cash or another financial asset and they do not meet the test of being entered into and continuing to be held for the purpose of receipt or delivery of non-financial items to meet the entity's expected purchase, sale or usage requirements (known as "own use commodity contracts"). Settling net includes taking delivery of the underlying and selling it within a short period after delivery to generate a profit from short-term fluctuations in price.

Note 5 – Loan commitments are outside IAS 39's scope if they cannot be settled net in cash or by some other financial instrument unless: they are designated as financial liabilities at fair value through profit or loss; or are held to generate assets of a class which the entity has a past practice of selling; or the commitment is to provide a loan at a below-market interest rate.

Note 6 – From the issuer's perspective, financial guarantee contracts are within IAS 39's scope, unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, in which case either IAS 39 or IFRS 4, 'Insurance contracts' may be applied.

Note 7 – Contracts with discretionary participation features are within the scope of IFRS 4, 'Insurance contracts'. The issuer of these instruments is exempt from applying paragraphs 15-32 and AG25-AG35 of IAS 32, 'Financial Instruments: presentation', regarding the distinction between financial liabilities and equity instruments. However, these instruments are subject to all other requirements of IAS 32.

1.7 The objectives and scope of IAS 32, IAS 39 and IFRS 7 are explained in greater detail in chapter 3.

Nature and characteristics of financial instruments

1.8 The definition of a financial instrument is set out in paragraph 1.6 above. One of the key components of the definition is that all financial instruments are defined by contracts. It follows that non-contractual obligations, such as taxation, are not financial instruments.

1.9 A financial asset is any asset that is:

- Cash.
- An equity instrument of another entity.
- A contractual right:
 - to receive cash or another financial asset from another entity; or
 - to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity.
- A contract that will or may be settled in the entity's own equity instruments and is:
 - a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
 - a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own

equity instruments do not include puttable financial instruments, instruments that impose on the entity an obligation to deliver to another party a *pro rata* share of the entity's net assets on liquidation and are classified as equity instruments, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

1.10 A financial liability is any liability that is:

- A contractual obligation:
 - to deliver cash or another financial asset to another entity; or
 - to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.
- A contract that will or may be settled in the entity's own equity instruments and is:
 - a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
 - a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants *pro rata* to all of the existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes, the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments, instruments that impose on the entity an obligation to deliver to another party a *pro rata* share of the entity's net assets only on liquidation and are classified as equity instruments, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

1.10.1 As an exception, certain puttable instruments and obligations arising on liquidation are classified as equity, despite the contractual requirement to deliver cash or another financial asset.

1.10.2 Classifying, as equity instruments, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency became effective for accounting periods beginning on or after 1 February 2010. Such classification only applies where the entity offers the rights, options or warrants *pro rata* to all of its existing owners of the same class of its own non-derivative equity instruments.

1.11 An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. Examples of equity instruments include non-puttable ordinary shares, some types of preference

shares, share warrants or written call options that allow the holder to subscribe for or purchase a fixed number of non-puttable ordinary shares in the issuing entity in exchange for a fixed amount of cash or another financial asset.

1.12 Derivatives are financial instruments that derive their value from an underlying price or index, such as an interest rate, a foreign exchange rate or commodity price. IAS 39 defines a derivative as a financial instrument or other contract with all of the following characteristics:

- Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').
- It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- It is settled at a future date.

1.13 The nature and characteristics of financial instruments are considered further in chapter 4.

Embedded derivatives

1.14 A derivative instrument that falls within IAS 39's scope need not be free-standing. Terms and conditions may also be embedded within another financial instrument or non-financial contract (referred to as the 'host' contract) that behave like a free standing derivative. These 'embedded derivatives' should be recognised at their fair value, separately from the non-derivative host contract, when they have economic characteristics and risks that are not closely related to those of the host contract. However, an entity may designate a contract that contains one or more embedded derivatives as a financial asset or financial liability at fair value through profit or loss, unless the embedded derivative does not significantly modify the cash flows otherwise required by the contract or it is clear that separation of the embedded derivative is prohibited.

1.15 Analysing non-derivative financial instruments and executory contracts for potential embedded derivatives is one of the more challenging aspects of IAS 39. This subject is considered further in chapter 5.

Classification of financial instruments

1.16 IAS 39 is a partial rather than a full fair value model. Financial assets and liabilities are measured at fair value or amortised cost depending on which defined category they fall into under the standard.

1.17 IAS 39 has four clearly defined categories of financial assets:

- A financial asset (or financial liability) is 'at fair value through profit or loss' if it is either:
 - Held-for-trading, that is:
 - it was acquired (or incurred) principally for the purpose of selling (or repurchasing) it in the near term;
 - it forms part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
 - it is a derivative (except for a derivative that is a designated and effective hedging instrument).
 - Designated on initial recognition as 'at fair value through profit or loss'. The conditions that are required to be met in order to designate a financial asset (or a financial liability) as 'at fair value through profit or loss' are any of the following:
 - Where the designation eliminates or significantly reduces an accounting mismatch.
 - When a group of financial assets, financial liabilities or both are managed and their performance is evaluated on a fair value basis in accordance with a documented risk management or investment strategy and information about this group is provided on that basis to the entity's key management personnel.
 - When a contract contains an embedded derivative that meets particular conditions.

The designation is irrevocable.

- Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, with the following exceptions:
 - Those that are to be sold immediately or in the near future (held-for-trading) and any others that are designated as 'at fair value through profit or loss' on initial recognition.
 - Those that are designated as available-for-sale on initial recognition.
 - Those where the entity may not recover substantially all of its original investment, other than because of credit deterioration. Such assets should be classified as available-for-sale.
- Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity (for example, debt securities, quoted loans and mandatory redeemable preferred shares) that an entity has the positive intention and ability to hold to maturity. Exceptions are those investments that an entity designates on initial recognition as 'at fair value

through profit or loss' or as 'available-for-sale' and those that meet the definition of 'loans and receivables'. Held-to-maturity instruments must have a maturity date, so investments in equity shares cannot fall into this category. There are a number of conditions set out in IAS 39 that restrict an entity's ability to categorise investments as held-to-maturity. For example, an entity may not classify any financial assets as held-to-maturity if during the current or preceding two financial years it has sold or reclassified more than an insignificant amount of held-to-maturity investments, except in certain very narrowly defined circumstances.

- Available-for-sale financial assets are non-derivative financial assets that are designated as such on initial recognition or that are not classified in any other category.

1.18 IAS 39 defines two categories of financial liabilities:

- A financial liability is 'at fair value through profit or loss' if it is either held-for-trading or designated at initial recognition as 'at fair value through profit or loss' (see the first major bullet point in para 1.17).
- All other financial liabilities fall into the other liabilities category.

1.19 The classification of financial assets and financial liabilities is considered further in chapter 6.

Financial liabilities and equity

1.20 The classification of a financial instrument as either a financial liability (debt) or equity is governed by the contractual arrangements' substance rather than its legal form. An instrument is debt when the issuer is or can be required to deliver either cash or another financial asset to the holder. This is the critical feature that distinguishes debt from equity. An instrument is classified as equity when it represents a residual interest in the issuer's net assets.

1.21 All relevant features need to be considered when classifying a financial instrument. The following are some basic examples of where an instrument will be classified as a financial liability disregarding, for the moment, the requirements for certain puttable instruments and obligations arising on liquidation:

- If the issuer can or will be forced to redeem the instrument, classification as debt is appropriate.
- If the choice of settling a financial instrument in cash or otherwise is contingent on the outcome of genuine circumstances beyond the control of both the issuer and the holder, the instrument is debt as the issuer does not have an unconditional right to avoid settlement.
- An instrument that includes an option for the holder to put the rights inherent in that instrument back to the issuer for cash or another financial instrument is debt.

1.21.1 Applying the requirements for certain puttable instruments and obligations arising on liquidation, some of the instruments in the first and third bullet points above that give the holder an equity-like return will be classified as equity, provided that all of the strict criteria in the amendment are met.

1.22 The treatment of interest, dividends, losses and gains in the income statement follows the classification of the related instrument. So, if a preference share is classified as debt, its coupon is shown as interest. But the coupon on an instrument that is treated as equity is shown as a distribution.

1.23 Not all instruments are either debt or equity. Some, known as compound instruments, contain elements of both in a single contract. Such instruments, such as bonds that are convertible into equity shares either mandatorily or at the holder's option, must be split into debt and equity components. Each is then accounted for separately. The debt element is determined first by fair valuing the cash flows excluding any equity component and the residual is assigned to equity.

1.24 Derivative contracts that only result in the delivery of a fixed amount of cash or other financial assets for a fixed number of an entity's own equity instruments are classified as equity instruments. All other derivatives on own equity are treated as derivatives and accounted for as such. This includes any that:

- can or must be settled on a net basis in cash (or other financial assets) or in shares;
- may be settled gross by delivery of a variable number of own shares; or
- may be settled by delivery of a fixed number of own shares for a variable amount of cash (or other financial assets).

Any derivative on own equity that gives either party a choice over how it is settled is a financial asset or liability, unless all of the settlement alternatives would result in equity classification.

1.25 The classification of financial instruments as either debt or equity and the treatment of contracts that may be settled in an entity's own shares are considered further in chapter 7.

Recognition and derecognition

1.26 A financial asset or liability is recognised on the balance sheet when an entity becomes a party to the contract. IAS 39's rules for removing or 'derecognising' a financial asset or liability are far more complex.

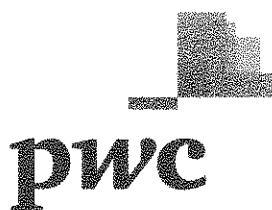
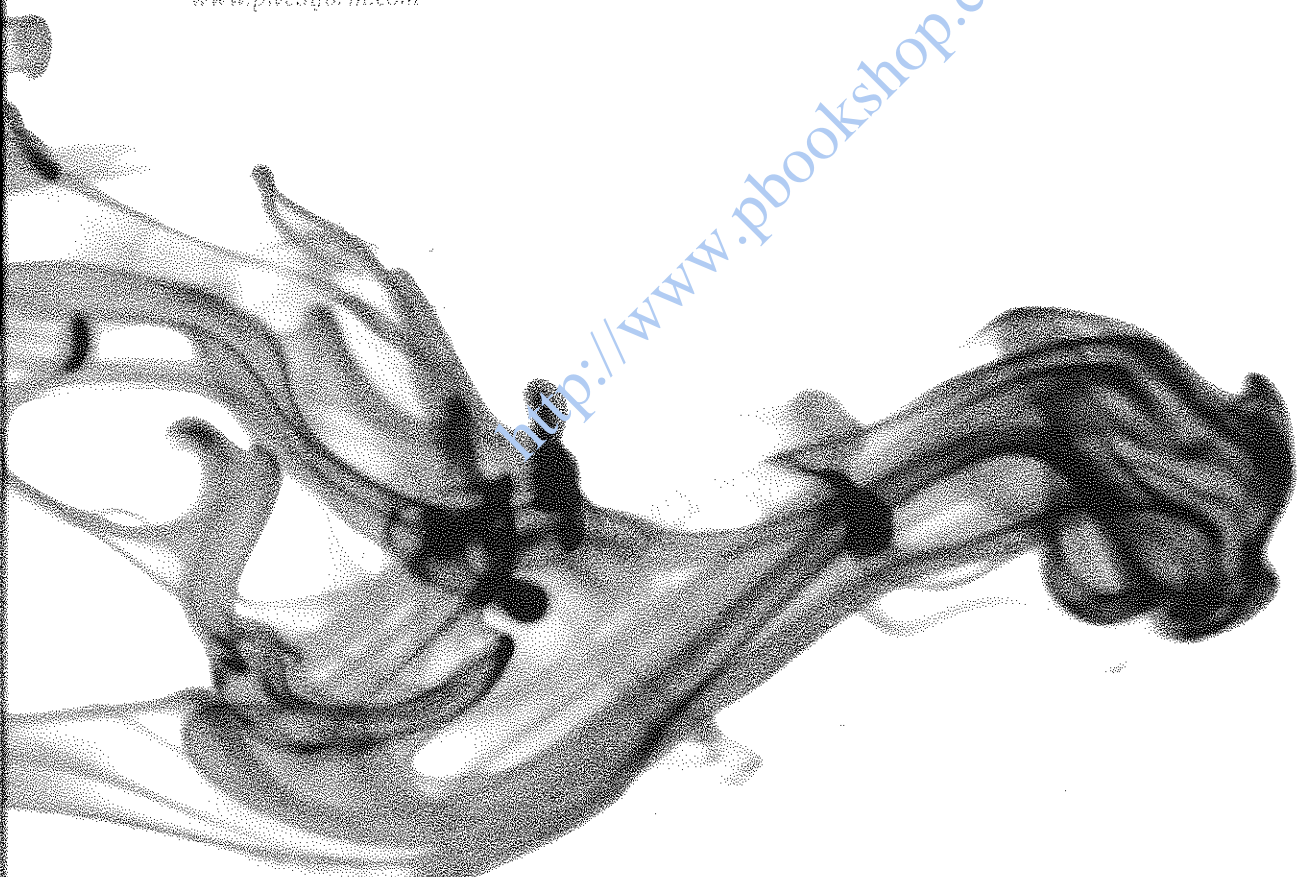
1.27 IAS 39 includes a flow chart that summarises the criteria for derecognising a financial asset and this is reproduced below.

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Contents

	Page
<i>Abbreviations and terms used</i>	P009
1 Introduction	1001
2 Directors' report	2001
3 Operating and financial review	3001
4 Corporate governance	4001
5 Disclosure of directors' remuneration	5001
Index	1001

<http://www.pbookshop.com>

2033
2033
2034
2035
2036
2037
2037
037
039
039
039
040
040
040
40
41

Chapter 2

Directors' report

Introduction

2.1 The directors' report is one of the mandatory components of a company's annual financial statements and reports for members. It must also be delivered to the Registrar of Companies by all companies except those entitled to the small companies exemption (see from para 2.143). [CA06 Secs 444(1), 444A(1), 445(1), 446(1), 447(1)].

2.2 The duty to prepare a directors' report is contained in section 415 of the Companies Act 2006. However, the Companies Act 2006 does not contain all the disclosure requirements: many of the detailed requirements are contained in Schedule 5 to SI 2008/409, 'The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008', for companies or groups falling within the definition of 'small' (see chapter 31 of the Manual of Accounting – UK GAAP) and Schedule 7 to SI 2008/410, 'The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008' for all other companies.

2.3 Directors have a responsibility to prepare the report even if none of the directors at the time the report is produced were directors during the period covered by the report. They cannot avoid this responsibility simply because they were not responsible for all or some of the activities that are being reported on.

2.4 The principal objectives of the directors' report are to supplement the information in the financial statements with discussions and explanations about the company's activities and its future and also to provide details of other non-financial matters. The purpose of the narrative information is to give the user of the financial statements a more complete picture of the company.

2.5 Listed companies regard the annual report and financial statements as an important mode of communication with shareholders. They, therefore, use the annual report to provide shareholders with information about all aspects of the company's activities and the environment in which it operates, the company's objectives and its values. Such information may be presented outside the statutory directors' report, for example, in the chairman's statement or in a separate operating and financial review (see further chapter 3).

2.6 Companies structure the 'front half' of their annual reports (that is, the elements of the annual report that come before the financial statements) in a variety of ways. The Companies Act 2006 gives directors safe harbour from civil liability for statements or omissions in the directors' report (and also the directors' remuneration report prepared by quoted companies) and as a result many identify the entire front half as the directors' report. (See para 2.150.1.) Others name the majority of the front half 'business review', or alternatively have separate sections for an operating, financial and/or business review, directors' report, corporate governance statement and directors' remuneration report.

2.7 In this chapter, we deal with the mandatory disclosure requirements that apply to the directors' report, including the business review. In addition to those requirements, the ASB has published non-mandatory good practice guidance on the operating and financial review (OFR). In deciding how to comply with the some of the disclosure requirements, companies may wish to consider that guidance. In discussing the various disclosure requirements in this chapter, we refer to chapter 3 on the OFR, when the ASB's statement provides guidance on the particular point under discussion.

[The next paragraph is 2.11.]

Companies reporting under IFRS

2.11 The requirements relating to the directors' report are contained within the body of the Companies Act and, thus, apply to all companies, regardless of whether the financial statements are prepared under IFRS or UK GAAP.

Consolidated financial statements

2.12 The Companies Act 2006 requires that, where an entity is a parent company and the directors prepare consolidated financial statements, the directors' report must be a consolidated report covering the company and its subsidiary undertakings included in the consolidation. [CA06 Sec 415(2)].

2.13 Where appropriate, the consolidated report should give greater emphasis to matters that are significant to the company and its subsidiary undertakings included in the consolidation, taken as a whole. [CA06 Sec 415(3)].

[The next paragraph is 2.16.]

Matters to be dealt with in the directors' report

Principal activities

2.16 The principal activities of both the company and of its subsidiaries during the year should be stated. [CA06 Sec 416(1)]. It is appropriate to include details of any significant change in the group's activities. Listed companies are required to go further and describe their business model (see para 2.21.40).

2.16.1 It is worth noting that a 'listed company' is not the same as a 'quoted company'. Rules applying to listed companies are set out in the FSA Handbook, which includes the Listing Rules, Disclosure Rules and Transparency Rules. Rules applying to quoted companies are set out in the Companies Act 2006. A company may be both 'listed' and 'quoted'; as such, it has to comply with both sets of rules. A 'listed company' is defined in the FSA Handbook as one that has any class of its securities listed. A 'quoted company' is defined as a company whose equity share capital:

- has been included in the official list in accordance with the provisions of Part VI of the Financial Services and Markets Act 2000;
- is officially listed in an EEA State; or
- is admitted to dealing on either the New York Stock Exchange or the exchange known as NASDAQ. [CA06 Sec 385].

2.16.2 The application of the definitions to different categories of company is set out in the table below.

Status of company's securities	FSA Handbook: 'listed company'	Companies Act 2006: 'quoted company'
Equity shares listed in the UK official list	✓	✓
Debt securities (but not equity shares) listed in the UK official list	✓	×
Equity shares listed in another EEA state or admitted to dealing on New York Stock Exchange or NASDAQ, but not on UK official list	×	✓
Equity shares traded on AIM	×	×

2.17 The term 'principal activities' is not defined in the Companies Act 2006. A useful description of a company's principal activities would describe what the company does to make money (or to achieve whatever other objective it has). Often, a company's activities are in diverse industries or classes of business, which represent segments for the purposes of its financial statements. Guidance is provided in SSAP 25, 'Segmental reporting', which defines a separate class of business as the distinguishable component of the entity that provides a separate product or service or a separate group of related products or services. [SSAP 25 para 11]. Distinguishable components of an entity may include, for example, mining, textiles, electrical etc. Broad categories such as manufacturing, wholesaling and retailing are not indicative of the industries in which the entity operates. Those terms should not generally be used to describe an entity's industry segments without identification of the products or services. IFRS 8, 'Operating segments', considers segments entirely differently and uses a 'through the eyes of management' approach. Under this approach, the operating segments reported externally are those that management uses as a basis for its decision-making.

[The next paragraph is 2.19.]

2.19 The categories of principal activities described in the directors' report should, as far as possible, be consistent with the information that is provided for segmental reporting purposes. So that investors can build a picture of the company from its component parts, it is desirable to have consistency between the description of the company's activities and the measurement of its performance. There are various factors that should be taken into account when deciding whether or not an entity operates in different industry segments and these are discussed further in chapter 10 on segmental reporting in both the Manual of Accounting – UK GAAP and the Manual of Accounting – IFRS for the UK.

2.20 A change in activity should be reported whenever there has been a commencement of a new activity or a complete withdrawal from a previous activity rather than a change in the degree of the activity undertaken. Such a change may be brought about by the acquisition or disposal of a subsidiary undertaking. In order to provide meaningful disclosure of the changes in activities, the extent to which the acquisition or disposal has impacted on any resultant change in the group's activities should be considered. Indeed, FRS 3, 'Reporting financial performance', requires that if an acquisition, a sale or a termination has a material impact on a major business segment, this impact should be disclosed and explained. [FRS 3 para 53]. IFRS 8's predecessor, IAS 14, 'Segment reporting', encouraged entities to disclose the nature and amount of any items of segment revenue and segment expense that were of such size, nature or incidence that their disclosure was relevant to explain the performance of each reportable segment for the period. [IAS 14 para 59]. Although there are no equivalent requirements in IFRS 8 or in UK GAAP, we consider such disclosure to be strongly recommended.

2.21 The degree of detail that should be given under principal activities will obviously depend upon the nature of the company's business. For companies operating in one or two business segments, the relevant information is normally given in the directors' report. Multinational corporations engaged in a wide range of business activities tend to include the relevant details elsewhere in the annual report and accounts, for example, in a separate statement that sets out a detailed review of their operations. Where this is done, a reference should be given in the directors' report to where the necessary information can be found. Table 2.1 provides an illustration of the disclosure of principal activities.

Table 2.1 — Principal activities

Smiths Group plc — Annual report and accounts — 31 July 2010

Group directors' report (extract)

Principal activities

The principal activities of the Company and its subsidiaries (the Group) are and, during the year ended 31 July 2010, were the development, manufacture, sale and support of:

- advanced security equipment, including trace detection, millimetre-wave, infrared, biological detection and diagnostics, that detect and identify explosives, narcotics, weapons, chemical agents, biohazards and contraband;
- mechanical seals, seal support systems, engineered bearings, power transmission couplings, specialist filtration systems and other hardware for the oil and gas, chemical, pharmaceutical, pulp and paper and mining sectors;
- medical devices aligned to specific therapies, principally airway, pain and temperature management, infusion, needle protection, critical care monitoring and vascular access;
- specialised electronic and radio frequency products that connect, protect and control critical systems for the global wireless telecommunications, aerospace, defence, space, medical, rail, test and industrial markets; and
- engineered components including ducting, hose assemblies and heating elements that move and heat fluids for the aerospace, medical, industrial, construction and domestic markets.

The main manufacturing operations are in the UK, the Americas, Continental Europe and China.

Business review

2.21.1 The directors should include in their report a review of the business of the company and its subsidiaries. [CA06 Sec 417(1)]. Where it is not included within the directors' report, the business review should be incorporated into the directors' report by specific cross-reference. Where a company is entitled to either the small companies or medium sized companies exemption (see further chapter 31 of the Manual of Accounting – UK GAAP), there are reduced disclosure requirements (see para 2.21.4 below).

2.21.2 The purpose of the business review is to inform the company's members and help them assess how the directors have performed their duty to promote the company's success. [CA06 Sec 417(2)].

2.21.3 In promoting the company's success, directors must, in particular, have regard to the following:

- The likely consequences of any decision in the long-term.
- The interests of the company's employees.
- The need to foster the company's business relationships with suppliers, customers and others.
- The impact of the company's operations on the community and the environment.
- The desirability for the company maintaining a reputation for high standards of business conduct.
- The need to act fairly as between the company's members.

[CA06 Sec 172].

2.21.3.1 The business review must be 'balanced and comprehensive'. [Sec 417(4)] A balanced review is one that reports both good and bad news. In a press notice, the FRRP reported that it had held discussions with Rio Tinto plc on whether additional information about some of the company's operations referred to in the 2008 business review ought to have been included in the review to comply with the legal requirement for a balanced analysis. Following those discussions, in their report and accounts for the year ended 31 December 2010, the directors of Rio Tinto plc included more information about environmental matters, social and community issues and related reputational risk.

2.21.3.2 Little authoritative guidance is available on the practical aspects of preparing a business review, which, for a large diverse company, could be detailed and complex. Although not written with the business review specifically in mind, the ASB's reporting statement on the OFR ('RS (OFR)') does deal with a number of its required disclosures, as shown in the table above. So, it is common for those preparing an OFR — which incorporates a statutory business review — or those simply preparing a business review as part of the directors' report to comply with the RS (OFR), to ensure that investors receive the most appropriate information. Hence, the example disclosures within the chapter on the OFR may also be considered when preparing a business review. See chapter 3 for guidance on the RS (OFR). Chapter 3 also provides information about publications that will be of assistance to companies preparing a business review, whether complying with the RS (OFR) or not. These publications and other good practice examples can be found at www.corporatereporting.com.

2.21.4 The legal requirements vary according to the type of company: a small company does not have to prepare a business review; all other companies must do so; but the reporting requirements vary depending on the company's size and status. A company will comply with the legal requirements for a business review if it elects to comply with the ASB's RS (CFR) (see chapter 3). This overlap between the law and the RS (OFR) is expressed diagrammatically below and described more fully in the subsequent paragraphs.

Type of company	Disclosure requirement	Non-mandatory guidance in the RS (OFR) paragraphs
Small company (see from para 2.143)	Business review not required. [Sec 417(1)].	
Medium-sized company	<ul style="list-style-type: none"> ■ The business review must contain, at a minimum: <ul style="list-style-type: none"> ■ A fair review of the company's business. ■ A description of the principal risks and uncertainties facing the company. ■ The review should be consistent with the business' size and complexity and provide a balanced and comprehensive analysis of: <ul style="list-style-type: none"> ■ The development and performance of the company's business during the financial year. ■ The company's position at the end of the year. ■ The review should also include, to the extent necessary for an understanding of the company's business, analysis using <i>financial</i> key performance indicators (KPIs). ■ The review must contain, where appropriate, references to and additional explanation of amounts included in the financial statements. 	<p>22, 30-32, 36-37</p> <p>27(c), 52-56</p> <p>27(b), 30-32, 43-46</p> <p>27(d), 30-32, 50-51, 60-74</p> <p>38-42, 75-77</p> <p>13-15</p>
Large unquoted company	<p>[Sec 417 (3), (4), (6)(a), (7), (8)].</p> <p>All of the above plus, where appropriate, analysis using other KPIs, including information on environmental and employee matters. [Sec 417(6)(b)].</p>	38-42,75-77
Quoted company (see para 2.16.1)	<ul style="list-style-type: none"> ■ The main trends and factors likely to affect the future development, performance and position of the company's business (see from para 2.37.6 below). ■ *Information about persons with whom the company has contractual or other arrangements that are essential to the company's business (see from para 2.21.35). ■ *Information about <ul style="list-style-type: none"> ■ environmental matters (including the impact of the company's business on the environment) (see from para 2.28); ■ the company's employees (see from para 2.28); ■ social and community issues (see from para 2.28); and ■ including information about any of the company's policies in relation to those matters and the effectiveness of those policies. 	<p>8-12, 27(b), 33-35, 47-49</p> <p>28(d),57-59</p> <p>28(a), (b), (c) 29,35</p>
	<p>[CA06 Sec 417(5)].</p> <p>The disclosures above are required "to the extent necessary for an understanding of the development, performance or position of the company's business".</p> <p>*If the review does not contain information on any of the items asterisked above, it must state that fact. [CA06 Sec 417(5)].</p>	

2.21.4.2 The meaning of 'quoted company' is discussed in paragraph 2.16.1.

2.21.4.3 Balanced reporting is discussed further in chapter 2.

2.21.5 Where an entity is a parent company and prepares consolidated financial statements, the business review should be a consolidated review covering the company and its subsidiary undertakings included in the consolidation. [CA06 Sec 417(9)]. There is no requirement for the parent company to prepare a separate review for the company alone.

[The next paragraph is 2.21.9.]

Applying the requirements to different types of company

2.21.9 As mentioned above, all companies must prepare a business review, other than those entitled to the small companies exemption (see para 2.21.1). The ASB's RS (OFR) offers some guidance on practically implementing the various business review requirements; this guidance is most often used by listed companies (see chapter 3). Guidance to assist directors in preparing a business review is limited for private entities, although it is open to them to use the RS (OFR) if they wish to do so.

2.21.10 Many of the requirements of the business review are preceded with the words "*to the extent necessary for an understanding of the development, performance or position of the company's business*"; this gives directors some discretion over the level of detail that should be presented in the business review.

2.21.11 Bearing in mind that the overriding purpose of the business review is as a tool for communicating with members (see para 2.21.2), we believe that the type and extent of disclosure required depends on the extent to which an entity's share ownership is dispersed and how close/involved the owners are to the business' management. This distinction can be illustrated as follows:

- *Owner-managed companies:* Members already have a good understanding of the company's development, performance and position. The minimum information to comply with the legislation is all that is needed to present a clear picture to members.
- *Wholly owned subsidiaries:* The position for wholly-owned subsidiaries of a parent company that actively monitors the business performance on an ongoing basis is similar to that for owner-managed companies. Often both the management and reporting of risk and key performance indicators for wholly-owned subsidiaries are undertaken at the group level. In such circumstances, it is appropriate to clarify this position and also to state that the company's directors believe that analysis using key performance indicators is not necessary or appropriate to understand the business' development, performance or position. The statement should usefully refer to further information available in the group annual report, making clear that it does not form part of the company's annual report. The cross-reference should be to a specific paragraph, heading, or page in the group annual report. See further paragraph 2.21.13 below.
- *Public interest, AIM-listed or separately managed private companies:* For public interest companies, AIM-listed (or PLUS-quoted) companies and private companies (including non-wholly owned subsidiaries) where ownership is distinct from those who manage the entity on members' behalf, the amount of information disclosed should reflect the explicit requirements implied by BIS in its pronouncements and guidance (for example, "*the business review would include information on objectives, strategies and resources where necessary to provide a fair review of the company*"). The minimum disclosures described for owner-managed entities should be supplemented by additional contextual information around risk and key performance indicators, as well as a description of the entity's strategy and business environment.
- *Quoted companies:* Fuller disclosure is necessary for quoted companies, to assist members in understanding the entity's development, performance and position. The most appropriate guidance is in the recommendations of the ASB's RS (OFR). (See chapter 3).

2.21.12 Given the broad nature of the categories set out above, and particularly public interest entities with dispersed ownership, there needs to be a degree of flexibility in the approach chosen by companies depending on their circumstances.