HEADLINE EARNINGS

Background

In September 1993, the Institute of Investment Management and Research in the United Kingdom (now the United Kingdom Society of Investment Professionals, UKSIP) issued Statement of Investment Practice No. 1 (SIP 1) (Appendix I to this document), which addressed the definition of Headline Earnings.

UKSIP Headline Earnings has been used in the calculation of the price/earnings ratios of the United Kingdom companies in the Financial Times since 1994 and has also been used by computer bureaus and other intermediaries in the United Kingdom. At the same time Headline Earnings has been adopted in South Africa not only for use by intermediaries but also as a standard definition for the announcement of company results.

The aim, as set out in Paragraph (vii) of the Summary of SIP 1 is "… to define an earnings figure calculated on a standard basis, which can be used as an unambiguous reference point …". It should be noted that SIP 1 in defining Headline Earnings in accordance with this aim delineates clearly between such a reference point and an earnings figure calculated as a measure of the company's maintainable earning capacity, which in the view of SIP 1 is a figure which cannot be calculated on a standard basis, but will vary from company to company and in other ways.

The characteristics of Headline Earnings (Paragraph (ix) of the Summary of SIP 1) are to:

- measure trading performance, separated from profits and losses on capital items;
- be robust; and
- be factual.

In the context of the work of the new International Accounting Standards Board, IASB, and in other discussions concerning accounting standards around the world, the question of reporting enterprise performance is now under strategic review. It may be that

the standards issued by IASB, and therefore the standards of many countries in the future, will move towards a single performance statement, rather than making a distinction between the traditional profit and loss account and items transferred directly to reserves in the balance sheet. As this work on a single performance statement continues, it will be necessary to review the formula for Headline Earnings. Consequential exposure drafts concerning any possible modifications to Headline Earnings will be issued at an appropriate time.

In the meantime, the UKSIP in conjunction with professional bodies in South Africa, has decided to issue the following Interpretation. This Interpretation takes account of the impact of the adoption of International Accounting Standards (IAS) in so far as this has progressed in South Africa. At this stage, IAS have not been introduced as such into the United Kingdom although many accounting standards in the United Kingdom (Financial Reporting Standards, FRS) are similar to IAS.[1]

In this context it should be noted in particular that IAS 39 has been introduced in South Africa but not in the United Kingdom. This affects the calculation of Headline Earnings due to the treatment of gains and losses on financial instruments. A definition of the financial instruments which are part of a trading operation and the use of the word "trading" may differ between IAS 39 and UKGAAP as incorporated into the text of SIP 1. This difference is delineated in the Interpretation. It should also be borne in mind when considering SIP 1 and the Interpretation that (as set out in paragraph 19 of SIP 1), the definition of Headline Earnings makes use of "the information provided in the accounts as building blocks, upon which information the user is entitled to rely". Thus the calculation of Headline Earnings as set out in SIP 1 does not address the frequent questions as to whether particular items should be classified in a certain way or another way, but relies upon the classification in the financial statements. SIP 1 only

[1] Note that the term IAS as used in this Interpretation includes both International Accounting Standards as well as International Financial Reporting Standards issued by the IASB.

indicates how the item should be treated in the calculation of Headline Earnings, assuming that the financial statement classification is correct.

This Interpretation should also be applied for purposes of calculating diluted Headline Earnings per share, as required by IAS 33. The circular should be applied retrospectively and where required, Headline Earnings figure previously published should be restated. Furthermore, where prior period results have been restated in accordance with IAS 8, Headline Earnings comparatives should also be restated.

This circular should be applied with immediate effect.

HEADLINE EARNINGS

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Issued December 2002

Interpretation of Statement of Investment Practice No. 1 –

Headline Earnings

December 2002

This Interpretation has been prepared in conjunction with the Chairman and members of the Headline Earnings Sub-Committee of the United Kingdom Society of Investment Professionals. It should be noted that International Accounting Standards are at present not implemented in the United Kingdom. Subject to this qualification, the United Kingdom Sub-Committee has surveyed and approved the Interpretation.

Issued December 2002

Interpretation

Reference is made to specific black letter paragraphs taken from SIP 1. In each case, reference is added to relevant new standards. In each case also, an explanation is added to clarify points which have arisen as a result of the introduction of the new standards, in addition to explanations already contained in SIP 1.

Paragraph 21 – Profits and losses arising in operations discontinued at some point during the year, or in operations acquired at some point during the year, should remain in the earnings figure. The profits or losses on the sale or termination of a discontinued operation should be excluded.

IAS 35 – Discontinuing operations, IAS 37 – Provisions, contingent liabilities and contingent assets as well as FRS 12 – Provisions, contingent liabilities and contingent assets, apply

Additional Explanation

In the setting of accounting standards reference may be made to "discontinuing operations" rather than "discontinued operations". This is a change in accounting terminology since the issuance of SIP 1. See Paragraph 4 of the Introduction to IAS 35 (1998). Although it is true that discontinuing operations may not have been finally discontinued, to the extent that they have been discontinued in terms of the definition thereof in this paragraph the original SIP 1 applies.

Profits and losses arising from a discontinuing operation should be included until the date of sale or termination. The profit or loss attributed to the discontinuance itself should however be excluded from Headline Earnings. This refers to any costs specifically attributable to the discontinuance such as employee termination costs, the effects of post-employment benefit plan curtailments, gains or losses on disposal of assets (including any discontinued operation sold or terminated as a whole) and settlement of liabilities, penalties on the cancellation of contracts, and site rehabilitation costs. Other costs, which benefit future non-discontinued operations, such as staff retraining costs and asset relocation costs, are included in Headline Earnings.

Restructuring costs which do not qualify as discontinuing operations, such as staff termination costs on downsizing of a business and business process re-engineering, are included in Headline Earnings to the extent that such costs relate to the trading activities of the enterprise. All capital gains and losses should be excluded.

Paragraph 22 – Profits and losses on the sale of fixed assets or of businesses, or on their permanent diminution in value or write-off, should be excluded. This does not apply to assets acquired for resale, such as marketable securities.

Addition to Paragraph 22 – Gains and losses arising from the adjustment to the fair value of fixed assets* should be excluded from the calculation of Headline Earnings. Losses arising from the impairment (also referred to as the permanent diminution in value) or write-off of fixed assets as well as any reversal of such losses should also be excluded from the calculation of Headline Earnings.

IAS 36 – Impairment of assets, IAS 39 – Financial instruments: recognition and measurement, IAS 40 – Investment property as well as FRS 11 – Impairment of fixed assets and Goodwill, apply

Additional Explanation
Profits and losses on the sale or impairment of operations or assets (other than a business operation sold as a whole, which may or may not be part of an activity explicitly discontinued) are included or excluded in Headline Earnings according to whether or not they are capital items which provide a platform from which the company can operate. Thus profits or losses resulting from the sale of items such as inventory or the write off of debtors will remain in Headline Earnings.

The terminology of Paragraph 22 refers to assets and investments "acquired for resale". This 1993 wording should be interpreted into the terminology now introduced by IAS 39. Assets "acquired for resale" in the original text are in IAS 39 terminology financial instruments held for trading. This category should not be confused with the IAS 39

* The term fixed assets refers to property, plant and equipment, as defined in IAS 16, as well as intangible assets, as defined in IAS 38.

category where certain financial instruments are classified as "available for sale".

The gains and losses recognised in the income statement which arise from adjustments to the fair value of investment properties should be excluded from the calculation of Headline Earnings. It should be noted that under the formula for Headline Earnings it may well be that investment companies (whether investing in properties or marketable investments) will, in accordance with SIP 1, exclude changes in value in these investments from Headline Earnings even if, as a result, the Headline Earnings figure is small as compared with movements in the capital value. This outcome reflects the nature of the companies concerned.

It should be noted that depreciation on fixed assets relates to the utilisation of the economic benefits of the assets (trading), whilst fair value adjustments and impairments relate to the platform on which the company's trading is carried on and can therefore be regarded as capital adjustments. The adjustments that result from trading should be included and those that result from capital adjustments should be excluded from Headline Earnings. If there is a change in the expected useful life of an asset then, insofar as there is an immediate charge, the effect is one of impairment. The adjusted depreciation over the remaining useful life of the relevant asset will be a normal inclusion in Headline Earnings in the future years.

Paragraph 22A – Adjustments to the carrying amounts of financial instruments (whether the result of revaluation, impairment or amortisation) and gains on losses on the realisation thereof should be dealt with in accordance with the accounting treatment in the financial statements. If an adjustment or gain or loss is included in the income statement, it should be included in Headline Earnings, but otherwise excluded. This inclusion applies to the amounts recognised in the income statement as a result of cash-flow hedges, even if those amounts have previously been recognised in equity. However, in those instances where fair value adjustments of available-for-sale financial instruments are recognised in equity but on disposal recycled through the income statement, the recycled amount is excluded from Headline Earnings.

IAS 39 – Financial instruments: recognition and measurement, applies

Explanation
It should be noted that IAS 39 is a conceptual compromise between the historical cost convention and the fair value convention and this is also true of the amendments to IAS 39. As a result of the mixing of the two approaches, certain questions as regards the allocation of gains and losses on financial instruments in the financial statements have been resolved by the standard setters on various grounds. In these circumstances, Headline Earnings accepts the financial statement treatment of the various outcomes for financial instruments and does not attempt to make adjustments which would run against the conclusions already arrived at. In all cases except one, therefore, the impact on the income statement (or the absence of any such impact) of the treatment of financial instruments is accepted in the calculation of Headline Earnings. The exception is that recycling from equity into the income statement of any gain or loss on an available-for-sale instrument is excluded from Headline Earnings.

Additional Paragraph 22B – Gains and losses arising from value adjustments to biological assets and agricultural produce should be included in Headline Earnings.

IAS 41 – Agriculture, applies

Explanation
A distinction is made in IAS 41 between biological assets that form part of a capital base of an enterprise (for example, an orchard or a dairy herd) and the agricultural produce of those assets (for example, fruit or milk) that represent inventories. However, IAS 41 passes both to the income statement, and does not require that the separate income statement consequences of these two groups should be disclosed, although it may be done in certain cases. In order to provide comparability, gains and losses arising from value adjustments to both biological assets and agricultural produce should be included in Headline Earnings.

Paragraph 25 – Provisions as recognised in the income statement in accordance with IAS 37 should be included at that time in Headline Earnings.

IAS 37 – Provisions, contingent liabilities and contingent assets as well as FRS 12 – Provisions, contingent liabilities and contingent assets, apply

Additional Explanation
This text replaces the original text of Paragraph 25.

The introduction of IAS 37 has led to a clear definition of provisions as genuine liabilities incurred in the year. If the degree of uncertainty is higher, the information is provided by way of note, as a contingent liability. Hence all provisions are liabilities in the year in question and the reversals previously discussed in Paragraph 25 are now unnecessary.

The treatment in Paragraph 25 will apply to provisions unless the provisions exclusively relate to the sale or termination of an operation in which case they are always excluded from Headline Earnings as set out in Paragraph 21.

Paragraph 26 – Goodwill should not affect earnings in any way.

IAS 22 – Business combinations as well as FRS 10 – Goodwill and intangible assets, apply

Additional Explanation
All goodwill should be excluded from the calculation of Headline Earnings, including any goodwill items relating to the enterprise's investment held in an associate. Negative goodwill, including that related to expectation of future losses and expenses that are identified on acquisition, should also have no effect on Headline Earnings in any way.

Any impairment to goodwill should (as in the case of amortisation of goodwill) be excluded from Headline Earnings.

Additional Paragraph 26A – The amortisation of intangible assets should be included in the calculation of Headline Earnings.

IAS 38 – Intangible assets as well as FRS 10 – Goodwill and intangible assets, apply

Explanation
IAS 38 (paragraph .84) states that the useful life of an intangible asset may be very long but it is always finite. IAS 38 distinguishes between (acquired) intangible assets and goodwill, which does not affect Headline Earnings in any way (Paragraph 26 above).

Paragraph 27

The following reference and Additional Explanation follows the existing Explanation to Paragraph 27:

IAS 19 – Employee benefits

Additional Explanation
In terms of the transitional provisions of IAS 19, an enterprise is allowed, if the transitional liability is more than the liability that would have been recognised at the same date under the enterprise's previous accounting policy, to make an irrevocable choice: either to recognise that increase in its defined benefit liability as an expense, on a straight-line basis over up to five years from the date of adoption; or to recognise that increase (as for any decrease) as an adjustment to the opening balance of retained earnings (IAS 8 and SIC 8). To achieve comparability, these increases should be excluded from Headline Earnings.

Paragraph 28

The following reference and Additional Explanation follows the existing Explanation to Paragraph 28:

IAS 21 – The effect of changes in foreign exchange rates

Additional Explanation
In terms of the provisions of IAS 21.30, an enterprise has to recognise a foreign currency translation reserve resulting from translating the financial statements of a foreign entity for incorporation in its financial statements. If such a foreign entity is subsequently disposed of, the foreign currency translation reserve will be realised through the income statement to accumulated profits. A similar situation exists on the realisation of an equity loan to a foreign entity. The effect of such a realisation should be excluded from Headline Earnings as it relates to capital items.

Additional Paragraph 30A - An increase or decrease in the provision for deferred tax resulting from a change in the applicable tax rate should be included in the calculation of Headline Earnings.

IAS 12 – Income taxes as well as FRS 19 – Income taxes, apply

Explanation
The income tax charged to the income statement should be included in Headline Earnings and therefore the recognition and write-off of deferred tax assets should be included in Headline Earnings. Only in instances where the tax expenses are attributable to an item which has been excluded from Headline Earnings should the tax charge or release also be excluded.

Appendix I

The Definition of

Headline Earnings

Statement of Investment Practice No. 1

(Issued in September 1993)

UNITED KINGDOM INSTITUTE OF INVESTMENT MANAGEMENT AND RESEARCH (NOW THE UNITED KINGDOM SOCIETY OF INVESTMENT PROFESSIONALS

In 1993 the analyst body in the United Kingdom, the Institute of Investment Management and Research, published "The Definition of Headline Earnings". This definition has subsequently been used for the calculation of earnings in the Financial Times, that is for the calculation of price/earnings ratios for United Kingdom companies, and for certain index calculations including United Kingdom companies. This work was done following the implementation of Financial Reporting Standard No. 3 in the United Kingdom – "Reporting Financial Performance", issued by the United Kingdom Accounting Standards Board.

In 2001 the name of the analyst body in the United Kingdom was changed to the United Kingdom Society of Investment Professionals, at the time of the merger between the British analysts and the Association for Investment Management and Research which is the world-wide body for the profession of investment managers and financial analysts.

The attached text is the original text as published in September 1993 in the United Kingdom, subject only to the exclusion of certain factual matters and the Appendices, which are not relevant to the situation in South Africa at present.

Definitions

This Statement of Investment Practice assumes the definitions set out on pages 8 and 9 of FRS 3.

In addition:

(a) This Statement uses the phrase abnormal items to comprise all items which are either exceptional or extraordinary, as defined by FRS 3.

(b) This Statement makes reference to trading income, from the company's operations, as opposed to capital items such as profits and losses on the sale of fixed assets or subsidiaries. In the context of the Statement, trading income is calculated to include interest received and after deduction of interest paid.

Summary

This Statement of Investment Practice sets out the conclusions of the relevant sub-committee of the Institute of Investment Management and Research on the methodology for the calculation of the earnings of a company or group in the light of the changes in published accounts implemented by FRS 3: that is, the Financial Reporting Standard 3 - 'Reporting Financial Performance' - issued by the Accounting Standards Board. i

The decisions set out in FRS 3 can be regarded as realistic and constructive. They are realistic in that they recognise that, both in this country and elsewhere, it has not been possible in the published accounts to make a clear and enforceable distinction between (in the original terminology) 'exceptional' items, which were included in earnings, and extraordinary' items, which were excluded from earnings. The proposals of FRS 3 are constructive in that the different ways in which profits and losses arise are now clearly delineated, with additional disclosures in relevant areas, including the disclosures necessary for adjustments for tax and minorities. As a result, users have a wider information set at their disposal. ii

The first sentence of paragraph 52 of FRS 3 states 'It is not possible to distil the performance of a complex organisation into a single measure'. This is manifestly true. One consequence of this fact is that to attempt to define a single earnings figure for all purposes is bound to fail. Any definition arrived at does not therefore have to refer to an ideal (and in fact non-existent) number, but only to a number chosen for some specified purpose; and different purposes may lead to different numbers. One number cannot do everything. iii

From the point of view of most users, however, two purposes stand out as of practical importance: iv

(a) A measure of the company's maintainable earning capacity, suitable in particular as a basis for forecasts and for inter-year comparisons, and for use on a per share basis in the calculation of the price/earnings ratio.

(b) A factual 'headline' figure for historic earnings which can be a benchmark figure for the trading outcome for the year.

These two concepts, which complement the FRS 3 bottom line figure, are discussed below.

The figure for 'maintainable' earnings

v The commitment of capital to an enterprise is normally made with a view to maximising the future stream of wealth which is generated by the enterprise, and this wealth will manifest itself in the surpluses generated for the shareholders, and especially in the figures for earnings. This approach points to a forward looking accounting system.

vi Thus, the earnings numbers taken in this context must be 'maintainable' - *the analysis of the past is carried out only as the basis for assessing the future*. This is particularly the case when an earnings per share figure is calculated for use in a price earnings ratio (PER), which implicitly assumes the company is going forward into the future. The calculation of an earnings number for this purpose requires that the historic figures are subject to considerable adjustments, in particular by the elimination of non-continuing items. Such adjustments require a degree of estimation and thus judgement, especially as the considerations involved may vary from case to case, and it is in the exercise of this judgement that individual analysts or research firms can add value on behalf of their clients. However, in view of the judgements required *the calculation of maintainable earnings figures cannot be put on a standardised basis*. Attempts to do so are bound to fail.

The HMR 'headline' figure for earnings

vii At the same time, it is clearly desirable to define an earnings figure, calculated on a standard basis, which can be used as an unambiguous reference point - between users, the press, the statistical companies etc. For such a purpose, the entry of a significant degree of judgement and variability into the calculation is undesirable and impractical. The IIMR has therefore defined a 'headline' earnings figure for use in this context. Even if the resulting figure is inferior to maintainable earnings

as a basis for forecasts it is robust and factual, and it is probably superior to many earnings figures used in these contexts, including PERs, in the past. The number is justified by its practical usefulness, even if it cannot, as one number, encapsulate the company's performance in itself.

This also raises the possibility that such a figure could be used by companies, in addition to the bottom line figure required by FRS 3, especially in preliminary and interim announcements: a lack of ambiguity in these announcements is important, since new and often significant information is involved and the market will react rapidly. viii

The figure for use as a reference point should have certain characteristics. First, it should be a measure of the *trading performance*, separated from profits and losses on capital items; the Accounting Standards Board could consider whether these capital items could be analysed separately in an expanded statement of total recognised gains and losses. Secondly, it should as far as possible be *robust*, so that the calculation can be carried through by anyone presented with the building blocks. These building blocks are the disclosures and distinctions laid down in FRS 3, on which the user is entitled to rely. Thirdly, the figure should be *factual*, including the incomes and costs which are actually reported in the accounts, and not subject to theoretical adjustments. *Thus whether or not an item will recur ceases to be a consideration*. The figure obtained in this way may well therefore differ from maintainable earnings in respect of the last two of these three points. ix

On the basis of these characteristics this Statement, in paragraphs 20 to 31 below, sets out the definition of IIMR 'headline' earnings. The principal points are: x

All the trading profits and losses of the company for the year (including interest) should be included in the earnings number. Abnormal trading items are included but should be prominently displayed in a note to the earnings figure if they are significant.

Profits and losses arising in operations discontinued at some point during the year, or in operations acquired at some point during the year,

should remain in the earnings figure. The profits or losses on the sale or termination of a discontinued operation should be excluded.

Profits and losses on the sale of fixed assets or of businesses, or on their permanent diminution in value or write-off, should be excluded. This does not apply to assets acquired for resale, such as marketable securities.

The Definition of Earnings

Introduction

1. In accounting jurisdictions around the world, including the United Kingdom, criticisms have over the years been levelled at the earnings figures which have been published by companies under previous regulations. These regulations have traditionally attempted to draw a distinction, when discussing profit and loss account items which are not completely normal in their origin or size, between (to use the original terminology) those items which are considered as `extraordinary', and therefore (originally) not to be included in the earnings number; and those which are considered 'exceptional', which, although they have some abnormality, are nevertheless to be included in the earnings number. It has been claimed that companies have attempted to call abnormal items 'exceptional' when they are profits, and to call them 'extraordinary' when they are losses, thus producing a flattering earnings picture. There has also been some uncertainty as to which items, even in theory, an earnings number should contain. In any case the distinction has been impossible to enforce.

2. Against this background, it can only be realistic to propose an `inclusive' profit and loss account figure, as laid down in FRS 3. Also, this inclusive figure has a value in itself in that it contains all the realised profits and losses of the company, and it may be considered as one measure of management's accountability. It would in the view of the sub-committee be preferable if in a future revision of FRS 3 this inclusive figure, if expressed on a per share basis, were not referred to as 'earnings' per share, which is what it is not, especially as even extraordinary items are included in the concept. It should be remembered that the word 'earnings' itself has the aura of its original and indeed its present essence, of reflecting the ongoing capacity of the company to generate wealth from operations, and it seems inappropriate to apply this word to the inclusive figure arising from the FRS 3 profit and loss account. Thus for example (and perhaps especially) the profits and losses on the sale of many capital items, such as businesses, are not easily seen by analysts as earnings.

3. On the other hand, the improved disclosures and clarifications now required by FRS 3 are constructive in that they provide a wider information set which enables the user to calculate an appropriate earnings number or numbers. It is the purpose of this Statement of Investment Practice to elaborate a suitable methodology for such a calculation. At the same time, companies themselves may wish to adopt the IIMR calculation of Headline Earnings as defined in this Statement, as the alternative allowed by FRS 3, and with the required reconciliation to the FRS 3 figure. In such cases care should be taken to ensure that the IIMR guidelines are followed in all instances, even when new items arise on the border line of the various distinctions.

4. One of the major thrusts of FRS 3 as regards its discussion of performance is that it is necessary to look further than a single bottom-line figure. The first sentence of paragraph 52 of FRS 3 states It is not possible to distil the performance of a complex organisation into a single measure'. This is manifestly true. The performance of a company is reflected in a complex and interlocking set of figures, which themselves interrelate with the industry and economic statistics. Thus for example an earnings figure will have a different significance if the company's balance sheet is strong, as compared to when it is under strain; and a different significance again if profits in the industry are cyclical as opposed to steady. The fact that there has been so much argument about the content of the earnings number in part reflects a widespread assumption (contrary to the points just elaborated) that there is a single figure for earnings, and that it is the single published earnings figure which determines share prices. It is perhaps because of this assumption that company management may have been influenced to maximise the earnings figure in the way that has been suggested.

5. In fact, as far as the capital markets are concerned - and it is the capital markets which many companies have in mind when discussing the earnings number - the evidence is that investors as a whole, as represented by the final share price on the stock market, take account of a wider information set than any particular published earnings figure. In any case, it is clear that the stock market would be an inefficient way of allocating the nation's savings if its valuations were influenced by a decision by the company to place a particular item of income in the

profit and loss account rather than a note, or as an exceptional rather than an extraordinary item, etc.

6. Nevertheless, even if investors are taking a broader view of published information, there are several reasons why efforts should be made to delineate some clearly acceptable earnings figure (or figures), rather than simply to assume that the market will sort things out for itself, even though the evidence may be that this is the case. The first reason is that in making its evaluation the market must presumably order the information in some useful way. If this is so, it would be reasonable and indeed desirable that the information should as far as possible be ordered in that way in the calculations of earnings. This is desirable also for a second reason, which is that there are a large number of users of accounts who do not have the time or the expertise to make the necessary detailed investigations which are distilled into the final market price. They should be provided with an understandable figure. In addition, on purely practical grounds , the reaction of commentators and of the stock market to company results may be confused if there is ambiguity in the figures announced. Some clear benchmark measure (or measures) of performance should therefore be available, which will be useful also for general reference when discussing company results.

7. *It is of the first importance to recognise that one consequence of the fact that a company's performance is reflected in a range of information, and not in a single number, is that to attempt to define a single earnings figure for all purposes is bound to fail.*

Only in a very simple business - say an investment company which held only cash balances put out at interest in a non-inflationary environment - would there be a single answer. In all normal situations, the interpretation of the earnings figure is affected by complex and often qualitative factors (cyclical forces, technological change, aspects of the capital position, etc), so that no single earnings figure can reflect everything. Once this is recognised, however, a considerable easing of the problem is achieved, since the definition arrived at does not have to refer to an ideal (and in fact non-existent) number, but only a number chosen for some defined purpose; and different purposes may lead to different numbers. This is one reason why the definition of earnings has caused so much dispute: commentators have often criticised any

particular proposal on the basis that it does not address this or that aspect of the problem. For example, a measure of purely trading results is criticised because it ignores wealth generated from gains on capital assets. By not looking for one all-encompassing figure, these controversies can be dissolved.

8. From the point of view of most users two purposes stand out as of practical importance:

   (a) A measure of the company's maintainable earning capacity, suitable in particular as a basis for forecasts and for inter-year comparisons, and for use on a per share basis in the calculation of the price/earnings ratio (PER).

   (b) A factual 'headline' figure for historic earnings which can be a benchmark figure for the trading outcome for the year.

   These two concepts, which complement the FRS 3 bottom line figure, are discussed below.

The figure for 'maintainable' earnings

9. The commitment of capital to the assets of an enterprise is normally made with a view to maximising the future stream of wealth which is generated by the enterprise subject to a control of the risks run. This wealth will manifest itself in the cash flows generated for the shareholders, and especially in the figures for earnings. The International Accounting Standards Board's Framework of Principles supports this approach by stating that the objective of financial statements is to enable the users to make decisions based upon the company's future cash flows - their size, timing and certainty.

Also, according to the Draft Statement of Principles, the assets of the company are engaged to generate this wealth from trading, and not as ends in themselves. If the company is significantly dependent on capital items (for example and in the extreme case, an investment property company), then to the extent that this is the case the earnings figure and the PER is less relevant and indeed misleading. This line of thought leads therefore to a concentration on the trading outcome, (not taking account of, in particular, the profits and losses on the sale of assets and businesses) when discussing the earnings concept.

10. In principle, the earnings number taken in this context must also be 'maintainable', since the analysis of the past is carried out only as a basis for assessing the future. The use of a PER indeed implicitly assumes that the company is a going concern, and looks to the future. This leads to the objective of calculating earnings numbers for past years which are the best basis for estimating the earnings for the next and subsequent years, and which facilitate inter-year comparisons.

11. It is necessary for this purpose to exclude from the calculation of earnings any earnings attributable to activities now discontinued; and to assume that any activity acquired should make its contribution for the full twelve months and not only for the period in the past year during which it was actually under the ownership of the new parent. Such calculations involve assumptions which are contrary to fact (because the discontinued operations and the acquired activities were in reality in the company's ownership only for part of the year). Furthermore, a good deal of judgement is required in setting up these assumptions: the

adjustments to the figures for discontinued activities or acquisitions require an estimation of the company's cost of capital, and should take account of any seasonal affect on profitability. Also the consequent adjustments to the tax charge may be uncertain.

12. In addition, in calculating the maintainable earnings, the adjustments for discontinued activities and for acquisitions will not be the end of the story. Abnormally large items arising from ordinary activities may clearly be items which will never recur, or which will recur rarely: for example, a company may have incurred large costs as a result of the move to the Single European Market. Analysts may well conclude that some (but not all) of this class of abnormal items should be excluded when calculating maintainable earnings. Whether an item is likely to recur is a central question.

13. Further, in the context of looking forward, certain accounting treatments may need to be reversed or at least interpreted, and considerations about the 'quality' of the earnings figure may come into play: in the case of a cyclical industry, the view taken about the future would be different from the view taken of an industry which demonstrates steady growth: this may affect the decisions taken on recurring/non-recurring items. Often the future will not replicate the past. In these and other matters, the earnings figure even for the past will be very much effected by judgement, so that answers may vary from analyst to analyst and from research firm to research firm. This judgement will require a knowledge not only of accounting items but also of the company as a whole and the industry and the economies in which it operates.

14. On the other hand, the PER and the earnings figure on which it is based are often published figures. They are shown by statistical services and in the statistical section of newspapers; they are part of the set of information which accompanies the calculation of national and international equity indices; and from these and other sources they are statistics frequently referred to. They claim therefore to have some objective basis. But because of the considerations set out above, the calculation of maintainable earnings cannot be factual and robust. There is no escape from this dilemma. The calculation of the 'correct'

earnings figure to be used in the PER and elsewhere cannot be standardised.

On the basis of these various arguments it can be concluded that not only is there no single number which encapsulates a company's performance, but also that the maintainable earnings figure, which is a valid concept, cannot be defined on a standardised basis. .15

This conclusion does not however set aside the second of the two uses of an earnings figure set out above, that is as a factual benchmark figure for the trading outcome of the year. .16

The IIMR headline figure for earnings

.17 Whatever other requirement there may be for an earnings figure it is clearly desirable, indeed virtually necessary, to define a figure for the company's earnings for the year which can be used as an unambiguous reference point - between users, the press, the statistical companies, etc. The inclusive nature of the FRS 3 bottom line figure rules it out for such a purpose. Not to have such a figure would mean that there was no commonly accepted benchmark; there would be a degree of confusion about the trading outcome which would be inconvenient at best. This raises the possibility that such a benchmark figure could also be used by companies, especially in preliminary and interim announcements, as a statement of earnings. Clarity and a lack of ambiguity in preliminary and interim statements is important as new and often significant information is involved about the trading picture and the stock market will react rapidly.

.18 The figure should for these purposes have certain characteristics.

First, it should on the principles described above be a measure of the company's *trading performance* in the year, not confused with capital items.

Secondly, it should as far as possible be *robust*. That is, the calculation should be one that can be carried through by anyone presented with the building blocks of the calculation. The building blocks are the disclosures in accounts as laid down in FRS 3 and delineated in this Statement of Investment Practice. In some cases judgements may unavoidably be required, but the aim should be to achieve unambiguous clarity in most instances.

Thirdly, the figure should be *factual*, including incomes and costs which are actually reported in the accounts, and not subject to theoretical adjustments, that is adjustments which require certain assumptions (even if these could be codified and therefore robust). ***This requirement rules out adjustments to the Headline Earnings figure on the grounds that items do or do not recur.***

.19 These considerations lead to a standard definition of IIMR Headline Earnings, as set out below. This figure for earnings is calculated for the purposes set out above, and may differ from the figures arrived at by the application of FRS 3 or other regulations whether statutory or not. It is intended as an additional and complementary figure, which can be reconciled to FRS 3 figures. In applying the definition, the user has no part in making the distinctions referred to in this Statement, but should use the information provided in the accounts as building blocks, upon which information the user is entitled to rely.

The definition of IIMR 'headline' earnings

20. **All the trading profits and losses of the company for the year (including interest) should be included in the earnings number. Abnormal trading items are included but should be prominently displayed in a note to the earnings figure if they are significant.**

    Explanation
    The Headline Earnings figure must reflect the outcomes of all the trading operations (including interest, but excluding 'capital' items) for the year.

    Some of the included items will be abnormal in size or in some other way (for example, large bad debts or restructuring costs). Whether or not these items may recur is not a consideration, but they should if significant be shown as an immediate qualification to the headline figure. The number of essential notes of this kind - which qualify the Headline Earnings - should be fairly limited and easily understandable.

    The relevant abnormal items will be disclosed in accounts (as 'exceptional') as a result of paragraphs 19 and 20(b) of FRS 3.

21. **Profits and losses arising in operations discontinued at some point during the year, or in operations acquired at some point during the year, should remain in the earnings figure. The profits or losses on the sale or termination of a discontinued operation should be excluded.**

    Explanation
    This decision results from the principle that the aim of the headline number is to be factual, and thus to report the trading earnings actually obtained in the year, even if from discontinued or newly acquired activities.

    In addition, to exclude all trading results from discontinued operations, and to include a full year's calculation of the trading results from an acquisition, would entail adjustments to the trading outcome and estimates of the interest paid or received on the capital sums involved. Such adjustments would require a number of assumptions (concerning the effect of the seasons on trading results, the cost of capital, etc.)

which would again be in violation of the principle that Headline Earnings should be factual (and robust).

Profits and losses on the sale or termination of an operation (FRS 3 paragraph 20(a) or 20(c)), are not included in the calculation of earnings, on the arguments set out below.

22. **Profits and losses on the sale of fixed assets or of businesses, or on their permanent diminution in value or write-off, should be excluded. This does not apply to assets acquired for resale, such as marketable securities.**

Explanation

The exclusion of profits and losses on the sale of 'capital' items will give a clearer picture of the ability of the company to generate wealth from its trading activities. The capital items reflect and affect the resources committed in producing the trading performance and are not the performance itself. The results of the asset changes are shown in the financial statements but are not part of the figure for earnings which is something different and which cannot reflect everything. Also, the activity in the capital items is of a different kind, will show a different volatility, and should be analysed separately.

Note that profits and losses on capital items are excluded even if they occur regularly.

Fixed assets sometimes suffer a permanent diminution in value whilst continuing in use. As a result, the published profit and loss account is impacted by the write-down of the fixed assets in question: such items should be excluded from the calculation of Headline Earnings; as in the case of the sale or the write-off of fixed assets, the permanent diminution in value of fixed assets can be considered a capital item.

A company may also acquire assets (such as marketable investments) with the intention of reselling in due course: profits and losses arising from these are not to be excluded as they have been acquired for `trading' purposes and are thus part of the trading performance. The distinction is made by FRS 3 paragraph 20, since under this paragraph profits and losses on the disposal of all fixed assets (and indeed businesses) should be disclosed.

This approach will lead to the exclusion from earnings of all the items contained in paragraphs 20(a) and 20(c) of FRS 3, and some of those in Paragraph 19.

23. **Profits and losses arising from the reorganisation or redemption of long term debt should be excluded when they are exceptional as defined in paragraph 5 of FRS 3.**

Explanation
These items should be excluded on arguments similar to those in Paragraph 22 above. They are capital items, which reflect on management's ability to manage the capital structure of the company, and are not part of trading. Items of this kind which are not exceptional as defined by FRS 3 can be considered as the normal cost of debt finance and are included.

24. **Prior period adjustments, that is the effect of changes in accounting policies and of past fundamental accounting errors, should not affect the current year's calculation of earnings. The record of historical earnings should be adjusted accordingly.**

Explanation
The requirements of FRS 3 (paragraph 29) ensure the correct treatment of these items in the published accounts and this treatment should carry over to the calculation of IIMR Headline Earnings and the historic record of these earnings. As in FRS 3 paragraph 7, prior period adjustments do not include normal recurring adjustments or corrections for accounting estimates made in prior periods.

25. **Provisions as disclosed in respect of items delineated in Paragraph 20 of FRS 3 should be reversed, so that the expenses are charged in the year in which they occur.**

Explanation
Provisions of this kind recognise the future consequences of commitments made in the current year and therefore distort the actual trading outcome for that year. Thus the FRS 3 paragraph 20 provisions for future costs and losses (for example on the sale or termination of an operation to be discontinued in a subsequent year) should be added

back and any such provisions made in past years and now released or invoked should be excluded.

26. **Goodwill should not affect earnings in any way.**

Explanation
Goodwill is not relevant to the trading activities of the company and if depreciated through the profit and loss account the figure in question should be added back to Headline Earnings. Any goodwill affecting the profit and loss account as a result of the sale of businesses, and brought forward from the past, should also be excluded on the grounds that it is a capital item and nothing to do with the trading performance of the company.

27. **Pension fund costs relevant to continuing activities (and other post-retirement benefit provisions if any) should be included in earnings, but prominently displayed in a note as in paragraph (20) above if of significant size.**

Explanation
Pension fund costs should be excluded from Headline Earnings if they arise from events connected with the discontinuation of an activity; but variations in costs can also arise in the normal course of events as a result of bull or bear markets for equities, changes in actuarial assessments etc. These are ordinary events and (for example) a reassessment of a pension fund, or the costs of converting it from a defined benefit scheme to a defined contribution scheme, should be treated as a part of earnings, prominently displayed if of significant size: and 'significant size' could refer to an unusually low transfer to the pension fund, a pension fund `holiday', or a credit transfer from the pension fund.

28. **Capital and trading items which arise in currencies other than the reporting currency should be handled in the same way as the equivalent items arising in the domestic currency.**

Explanation
The fact that certain items arise in currencies other than the reporting currency does not offset any of the points of principle discussed above, even if certain additional items arise in the translation of foreign

currency assets, liabilities and operations. Thus if there are changes in the valuation in the domestic currency of long-term foreign assets or liabilities as a result of currency movements, the arguments are the same: these are changes in the asset base, and should not affect the performance as reflected in the Headline Earnings number. This performance, and the Headline Earnings figure, are of course impacted by currency effects on trading transactions.

29. **The calculation of the Headline Earnings number should include tax (and where relevant, minority interests) adjustments to reflect the fact that certain items are excluded from the headline figure. Companies are encouraged to provide the necessary disclosures if these are not already required.**

    Explanation
    The disclosures required in FRS 3 (especially in paragraphs 20, 23, 24 and 50) are such as to provide the information required for the adjustments arising from the exclusion of the items described in paragraph 20 of FRS 3, and probably for other exceptional items also. Most adjustment in practice will concern FRS 3 paragraph 20 items. If the average tax rate in fact applies across the exceptional items in question, that fact should be disclosed.

    Should a company wish to produce the IIMR Headline Earnings figure at the time of a preliminary or interim announcement, it will be necessary to include in that announcement the tax (and minority interest) adjustments required by FRS 3.

30. **Apart from adjustments as in Paragraph 29, the calculation of Headline Earnings should normally reflect the tax charge as shown in the company accounts.**

    Explanation
    Although there may be some items in the tax charge which refer to taxation in previous years the matter is not a simple one. To some extent taxation is a rolling calculation and to attempt to recalculate the charge will very frequently lead to an answer which is neither factual nor robust. This is in line with FRS 3 paragraph 7, which defines prior period adjustments as not including normal recurring adjustments or corrections for accounting estimates made in prior periods.

Extraordinary items should be excluded. 31.

Explanation
According to the FRS 3 definition (paragraph 6) extraordinary items are "Material items possessing a high degree of abnormality which arise from events or transactions that fall outside the ordinary activities of the reporting entity and which are not expected to recur

The second of these criteria does not affect the treatment of these items in Headline Earnings since whether or not an item may recur is not a consideration. The highly abnormal nature of the activity, however, leads to the exclusion of the item. FRS 3 requires disclosure of the relevant effects of tax and minority interests.

The use of IIMR Headline Earnings in price earnings ratios

32. The use of 'maintainable' earnings in the calculation of PERs is intellectually valid. The difficulty is that maintainable earnings cannot be calculated on a standardised basis, whereas PERs are frequently published in objective contexts such as newspapers, statistical services, etc, where a standardised approach is necessary and the use of judgement in this calculation undesirable and impractical.

33. It is however true that the PER could be calculated on the basis of Headline Earnings, which can be objectively defined as set out in this Statement. This would give rise to figures which, although somewhat inappropriate compared with those which result from a true analysis of the use of the PER, would in any case be as reliable, and indeed probably more reliable, than most of the PERs calculated in the United Kingdom on the basis of past published profit and loss account earnings figures. The headline figures are therefore suitable for publication in objective contexts such as newspapers and statistical services.

34. In addition, individual analysts and research houses, and other users, may if they wish analyse the financial statements in more detail, judge the quality of the earnings carefully, and produce their own recommended (and especially future estimates of) earnings figures and PERs for their clients. It is sometimes argued that this would cause confusion in view of the multiplicity of figures: but the maintainable earnings figure will justifiably vary from user to user, just as judgement will vary. In any case, the criticism which is brought against the multiplicity of earnings estimates can to some extent be set aside if there is a core definition which is unambiguous and accepted by all parties, such as the IIMR headline figure for earnings which is recommended in this Statement, and from which other definitions of earnings can be built up.

Appendix 2

Specific Application Issues

This Appendix should be read in conjunction with the Circular and is intended to clarify the application of the requirements of the Circular to issues which have been identified as causing uncertainty or diversity in practice and brought to the attention of the Accounting Practices Committee (APC). The date on which the APC concluded on each of the matters raised is set out below. This Appendix is updated periodically with details and conclusions on matters affecting the application of the Circular and posted on the SAICAs website, as part of the Circular.

Issue 1

Application of Circular 7/2002 - *Headline Earnings* prior to adoption of IAS 39(AC 133) - *Financial Instruments: recognition and measurement*

The question arises as to whether Paragraph 22A of Circular 7/2002 is applicable to financial instruments before the implementation of IAS 39(AC 133). If so, this could result in inconsistent treatment of such instruments in Headline Earnings over different periods until such time as IAS 39(AC 133) has been implemented. This inconsistency is as a result of the change introduced by Circular 7/2002.

For example, adjustments recognised in the income statement to the carrying amounts of financial instruments which would have been classified as available-for-sale financial instruments had IAS 39(AC 133) been implemented, have generally been interpreted as being of a capital nature prior to the implementation of IAS 39(AC 133) and thus excluded from Headline Earnings. In terms of Circular 7/2002 and following the implementation of IAS 39(AC 133), an entity will, on electing to account for available-for-sale fair value adjustments directly through equity, exclude such adjustments from Headline Earnings. However, where the entity elects under IAS 39(AC 133) to include such fair value adjustments in net

profit or loss for the period these adjustments are also included in Headline Earnings.

Conclusion

Paragraph 22A of Circular 7/2002 should be applied only when an entity has implemented IAS 39(AC 133). As IAS 39(AC 133) requires prospective implementation, it follows that the application of Paragraph 22A of Circular 7/2002 is also prospective.

Prior to the implementation of IAS 39(AC 133) by an entity, the overriding principle of Headline Earnings (trading versus capital) should be applied to adjustments to the carrying amounts of financial instruments when calculating Headline Earnings.

Basis for conclusion

Paragraph 22A of Circular 7/2002 interprets IAS 39(AC 133) specifically. It follows that Paragraph 22A of Circular 7/2002 is not applicable before IAS 39(AC 133) is implemented.

Date of Accounting Practices Committee Consensus:

6 March 2003

Issue 2

Application of Circular 7/2002 – *Headline Earnings* to loss-making associates, after adoption of IAS 39(AC 133) - *Financial Instruments: recognition and measurement*

Associates may be funded by their parent companies either through investments in the equity of the associate, or by providing a loan to the associate, or both. The question arises as to how impairments of investments in the equity of equity accounted investments in associates and impairments of loans to equity accounted associates should be treated when calculating Headline Earnings. For the purposes of this question, investments in the equity of equity accounted associates are those investments included in the carrying amount of the associate in terms of SIC 20(AC 420) - *Equity Accounting Method – Recognition of Losses*, paragraph 05.

Conclusion

Impairments of equity accounted investments in associates should be excluded from Headline Earnings. Impairments of loans to equity accounted associates should be included in Headline Earnings.

Furthermore, Paragraph 22A of Circular 7/2002 should be applied only when an entity has implemented IAS 39(AC 133). As IAS 39(AC 133) requires prospective implementation, it follows that the application of Paragraph 22A of Circular 7/2002 is also prospective.

Basis for conclusion

IAS 39(AC 133) does not apply to interests in associates that are accounted for under IAS 28(AC 110) - *Accounting for Investments in Associates*. In these circumstances, the equity investment in the associate is not a *"financial instrument"* as defined by IAS 39 (AC 133). Paragraph 22 of the circular states that profits and losses on the sale of fixed assets or of businesses, or on their permanent diminution in value or write-off should be excluded from Headline Earnings. Impairment of an investment in the equity of an equity accounted investment in an associate should be excluded from Headline Earnings as this relates to an impairment of a *"business"*.

A loan to an equity accounted associate, on the other hand, is a *"financial instrument"* as defined by IAS 39(AC 133). Paragraph 22A states that fair value adjustments, including impairments, on financial instruments that are recognised in the income statement, remain in Headline Earnings. Prior to the implementation of IAS 39(AC 133) the loan did not have to be classified as a financial instrument and accordingly any impairment of the loan could have been classified as a capital item, which may have been adjusted in Headline Earnings.

Date of Accounting Practices Committee Consensus:

3 April 2003

Issue 3

Application of Circular 7/2002 - *Headline Earnings* to equity accounted earnings from associates/joint ventures

The question arises as to how Circular 7/2002 should be applied to equity accounted earnings from associates/joint ventures. There are two conceivable approaches:

- The equity accounted earnings should be regarded as representing the net trading profits/losses from associates/joint ventures and should therefore be included in the Headline Earnings calculation without adjustment; or
- A "look through" approach should be adopted whereby Circular 7/2002 should be applied to individual items within the associates/joint ventures that make up the equity accounted earnings figure.

Conclusion

A "look through" approach should be followed. Circular 7/2002 should be applied to individual items within the associates/joint ventures that make up the equity accounted earnings figure of the reporting entity.

The nature and amount of any adjusting items arising from the associates/joint ventures should be disclosed in the financial statements of the reporting entity.

Basis for conclusion

The calculation of Headline Earnings takes into account individual items in consolidated subsidiaries.

Under IAS 31(AC119) – *Financial Reporting of Interests in Joint Ventures*, a joint venturer accounts for its interests in joint ventures using either proportionate consolidation or the equity accounting method. In terms of IAS 31(AC 119) paragraph 28, many of the procedures appropriate for the application of proportionate consolidation are similar to consolidation procedures. Therefore, where proportionate consolidation is applied, Circular 7/2002 is

effectively applied to individual items within the joint ventures that make up the consolidated earnings figure.

The equity method may be applied to associates or joint ventures IAS 31((AC 119) paragraphs 33-34). Under IAS 28(AC 110) - *Accounting for Investments in Associates*, paragraph 15, many of the procedures appropriate for the application of the equity method are similar to consolidation procedures.

It follows that, in calculating Headline Earnings, the same principles should be applied to consolidated subsidiaries, proportionately consolidated joint ventures, or equity accounted associates/joint ventures.

The calculation of Headline Earnings utilises the information provided in the accounts as building blocks, upon which information the user is entitled to rely and all significant items should have been disclosed in the financial statements of the associates/joint ventures.

Consequently, the reporting entity must take such information into account in its own Headline Earnings calculation and apply Circular 7/2002 to each item arising in the financial statements of the associates/joint ventures individually.

Date of Accounting Practices Committee Consensus:

2 October 2003

Issue 4

Application of Circular 7/2002 - *Headline Earnings* to discontinuing operations and businesses

Divergent practice has emerged on how Circular 7/2002 is applied to business disposals, closures and other discontinuing operations as a result of the use of different terminology in Paragraphs 21 and 22 of SIP I, Appendix 1 of Circular 7/2002.

In discussing Paragraph 21 of SIP 1, Appendix I of Circular 7/2002 includes a reference to IAS 35(AC 117) - *Discontinuing Operations*. This may be interpreted as meaning that only gains or losses arising on the discontinuance of an operation as contemplated in IAS 35(AC 117) should be excluded in determining Headline Earnings. The definition of a discontinuing operation in IAS 35(AC 117) includes that the component being discontinued represents a separate major line of business or geographical area of operations.

On the other hand, Paragraph 22 of Circular 7/2002 states that *"Profits or losses on the sale of fixed assets or of businesses, or on their permanent diminution in value or write-off, should be excluded."*

In determining Headline Earnings, the question therefore arises as to how to treat the profit or loss arising on the termination (other than by sale) and write-off of a business which would not meet the definition of a discontinuing operation in IAS 35(AC 117).

Conclusion

All gains and losses directly attributable to the sale or termination of a business (other than trading results up to the date of sale), whether or not the business constitutes a discontinuing operation as defined in IAS 35(AC 117), should be excluded from Headline Earnings. Any other restructuring or similar costs relating to ongoing operations shall be included in Headline Earnings.

Basis for conclusion

A situation could occur where a "business" that does not meet the criteria in IAS 35(AC 117) of a "discontinuing operation" is sold for a nominal amount, resulting in a loss on the sale. This could result in the loss on the sale being excluded from Headline Earnings under Paragraph 22, whereas if the same business were instead to be closed, the resulting loss (other than fixed asset impairments) would, under Paragraph 21, be included in Headline Earnings.

An example is the retail environment, where a branch is closed down. This is a separate business of the entity, but would not be classified as a discontinued operation per IAS 35(AC 117).

This apparent anomaly arises because of the use of different terminology in IAS 35(AC 117) and Paragraphs 21 and 22 of SIP 1 respectively. The use of different terminology in SIP 1 and Circular 7/2002 should not lead to inconsistent treatment of similar items in Headline Earnings.

Date of Accounting Practices Committee Consensus:

30 January 2004

Issue 5

Application of Circular 7/2002 – *Headline Earnings* to the exchange differences arising on a foreign currency liability accounted for as a hedge of the net investment in a foreign entity

IAS 39(AC 133) – *Financial Instruments: Recognition and Measurement* and IAS 21(AC 112) – *The Effects of Changes in Foreign Exchange Rates* require that the exchange differences arising on a hedge of an enterprise's net investment in a foreign entity should be recognised directly in equity in the enterprise's financial statements until the disposal of the net investment, at which time they should be recognised as income or expense.

Paragraph 22A of Circular 7/2002 does not address the treatment of the exchange differences whilst deferred in equity or when they are recognised as income or expense.

Conclusion

The exchange differences arising on a hedge of an enterprise's net investment in a foreign entity are excluded from the calculation of Headline Earnings:

- while deferred in equity; and
- when included in the net gain/loss on the disposal of the net investment.

Basis for conclusion

IAS 21(AC 112) and IAS 39(AC 133) clearly link the hedge to the net investment in the foreign entity.

This, along with the requirement that the exchange difference is only released to income or expense on the disposal of the net investment, confirms that the amount released is capital in nature.

Further, the nature of the exchange difference recognised as income or expense is addressed by Paragraph 22 of Circular 7/2002 – Profits and losses on the sale of fixed assets or of businesses, or on their permanent diminution in value or write-off, should be excluded.

Date of Accounting Practices Committee Consensus:

18 March 2004

Issue 6

Application of Circular 7/2002 – *Headline Earnings* to foreign exchange differences on financial instruments and "capital items"

IAS 21(AC112) – *The Effects of Changes in Foreign Exchange Rates* requires that the exchange differences arising on all monetary items denominated in foreign currency be included in profit and loss for the period. IAS 39(AC 133) – *Financial Instruments: Recognition and Measurement* and its implementation guidance specify differing treatment of foreign exchange losses arising on financial instruments carried at fair value (both held for trading and available-for-sale) and financial instruments that are monetary or non-monetary. It also addresses issues that arise with financial instruments in the financial statements of foreign entities and hedges of such investments.

Paragraph 22A of Circular 7/2002 requires, with one limited exception, that adjustments to the carrying amounts of financial instruments and the related realisation gains and losses be treated in a similar way for Headline Earnings purposes to the accounting treatment.

Paragraph 28 of Circular 7/2002 requires that foreign exchange movements on capital items be excluded from the calculation of headline earnings.

The application of these paragraphs is unclear and liable to contradictory interpretation in the following instances:

- It is unclear whether Paragraph 22A of the Circular applies to any foreign exchange movements on financial instruments rather than Paragraph 28 of the circular. It is also unclear whether this applies to items falling under IAS 39(AC 133) only. It is noted that IAS 39(AC 133) does not distinguish between trading items and non-trading/capital items, nor between long- and short-term items.
- For financial instruments originated by the entity with a long-term or capital nature, the explanation to Paragraph 28 contradicts the guidance in Paragraph 22A of the circular. This is also the case for integrated foreign operations with long-term or short-term originated loans.

- Under IAS 21(AC 112), the foreign currency movement on monetary items is taken to profit and loss, notwithstanding whether the item is a financial instrument classified as available-for-sale or a capital or trading item. It is unclear whether such foreign currency movements are to be accounted for under Paragraph 22A or Paragraph 28 of Circular 7/2002.
- It is unclear whether Paragraph 22A or Paragraph 28 of the Circular should apply to foreign exchange movements on other monetary items not accounted for as financial instruments under IAS 39(AC 133), such as foreign currency long-term lease receivables/payables.

Conclusion

Foreign currency movements on all monetary items associate more to the entity's financing decisions than to decisions relating to the underlying assets or liabilities. Financing costs are included in headline earnings and therefore so should foreign exchange movements.

All foreign currency adjustments on financial instruments in terms of IAS 21(AC 112) should be included in Headline Earnings. Where these adjustments form part of the recycled amounts for cashflow hedging as well as on the realisation of available-for-sale non-monetary assets (i.e. the deferral in equity method is applied), the foreign currency adjustments would be excluded from Headline Earnings.

For monetary items scoped out of IAS 39(AC 133) such as lease receivables and payables, the same treatment as for financial instruments should apply.

Basis for conclusion

One aim of the interpretation in South Africa was to take account of the impact of the alignment with International Financial Reporting Standards (IFRS). Under IFRS, foreign currency movements are not delineated between capital or trading items, nor long-term or short-term items, but are rather distinguished between monetary and non-monetary items. Similarly, a detailed breakdown of foreign currency movements is not required.

Paragraph 22A of the circular makes it clear that the relevant accounting treatment as regards foreign currency movements on financial instruments should be followed for purposes of Headline Earnings.

Monetary items not accounted for as financial instruments under IAS 39(AC 133) such as lease receivables and payables fall under the definition of a financial instrument but are scoped out of IAS 39(AC 133) since the measurement rules for these are in IAS 17(AC 105). It would be inconsistent to treat foreign currency adjustments on these type of items differently to those on other monetary items.

Date of Accounting Practices Committee Consensus:

18 March 2004

Issue 7

Application of Circular 7/2002 – *Headline Earnings* to the expensing of the cost of BEE equity credentials in terms of IFRS 2 (AC 139) – *Share-based Payment*

Where as a result of the issue of IFRIC 8(AC 441) – Scope of IFRS 2 and AC 503 – *Accounting for Black Economic (BEE) Transactions*, BEE transactions result in an expense because the fair value of the equity instruments granted or the liability incurred is greater than the cash and other assets received, the question arises as to whether this expense is included in or excluded from Headline Earnings.

Conclusion

The expense arising from a BEE transaction relating to BEE equity credentials, should be included in Headline Earnings.

Basis for conclusion

BEE equity credentials are necessary within the South African environment for an entity to participate in tenders and other concessions by government. The expense is essentially the cost of both protecting and expanding business within South Africa, similar to a marketing cost. As discussed in more detail in AC503, the difference between the fair value of equity instruments granted and the cash and other assets received (i.e. the BEE equity credentials) represents an intangible item that does not meet the definition of an intangible asset. This difference does not qualify for recognition as an intangible asset and is to be expensed. Using the same reasoning, this expense cannot be considered to be a capital item or a part of the platform from which the company can operate and the expense can, accordingly, not be adjusted for purposes of Headline Earnings. The consideration of capital versus trading is used in the absence of any more specific rule in Circular 7/2002.

Date of Accounting Practices Committee Consensus:
30 March 2006

Issue 8

Application of Circular 7/2002 - *Headline Earnings* to profit or loss on disposal of associates that have been equity accounted by private equity and venture capital organisations

IAS 28(AC 110) - *Investments in Associates*, which was revised and is effective for annual periods beginning on or after 1 January 2005, states in the scope of the standard that "*This Standard shall be applied in accounting for investments in associates. However, it does not apply to investments in associates held by:*

(a) venture capital organisations,
(b) mutual funds, unit trusts and similar entities including investment-linked insurance funds

that upon initial recognition are designated as at fair value through profit or loss or are classified as held for trading and accounted for in accordance with IAS 39 Financial Instruments: Recognition and Measurement. Such investments shall be measured at fair value in accordance with IAS 39, with changes in fair value recognised in profit or loss in the period of the change." This therefore provides the option to private equity and venture capital organisations either to equity account investments in associates or to designate the investments at fair value through profit and loss on initial recognition.

Where such an organisation has designated the investments in associates at fair value through profit and loss on initial recognition, all fair value adjustments, including any profit or loss at the time of sale of the investments, will be included in Headline Earnings.

The question arises as to how Circular 7/2002 should be applied to any profit or loss on sale of investments in associates that have been equity accounted by such organisations.

Conclusion

Where a private equity or venture capital organisation had chosen to equity account investments in associates, any profit or loss on the sale of such investments should be excluded from Headline Earnings.

Basis for conclusion

Paragraph 22 of Circular 7/2002 states that "*Profits and losses on the sale of fixed assets or of businesses, or on their permanent diminution in value or write-off, should be excluded. This does not apply to assets acquired for resale, such as marketable securities.*"

Investments of private equity and venture capital organisations are held for resale purposes, but not for short-term profit taking as envisaged in IAS 39(AC 133), and such investments fall within *"businesses"* as described by paragraph 22 of Circular 7/2002.

While it is acknowledged that this will result in a different impact on Headline Earnings, depending on the accounting policy selected, this is considered appropriate as those entities that wish the amounts to be included in Headline Earnings have the option of designating the investments at fair value through profit and loss on initial recognition. There is a precedent in the circular for different treatment of the same transaction in respect of equity investments, where those designated at fair value through equity available-for-sale will be excluded from Headline Earnings upon realisation and those designated at fair value through profit and loss will be included in Headline Earnings.

The argument that the investments were acquired with the intention of being sold at a profit was also considered, but was dismissed as that intention also applies to both available-for-sale financial instruments and investment properties, both of which are excluded from Headline Earnings in terms of this circular.

Date of Accounting Practices Committee Consensus:
20 April 2006