

# Sources of authority: the United Kingdom

## chapter 2

### overview

There is a large and increasing body of rules with which accountants need to be familiar when preparing or interpreting a set of financial statements. In some countries most of the rules are laid down in the law while, in other countries, the law contains principles only with the major rules being laid down in accounting standards.

Companies must comply with both the relevant law and applicable accounting standards, although the sanctions that will be applied for non-compliance with each may differ. Companies that have their shares publicly traded on a Stock Exchange must also comply with the rules of that Stock Exchange.

In this chapter, we explore all three sources of rules – the law, accounting standards and the Stock Exchange – within the present UK context. Here and throughout the book, we concentrate on ‘big GAAP’, the rules which apply to large companies and groups, rather than the special rules which apply to small and medium-sized companies.

In 1998, the Government embarked on an extensive review of British company law. After considering the Final Report of the Company Law Steering Group, it published a White Paper in July 2002 which proposes major changes to rule making in the United Kingdom. We examine the proposals to delegate the making of rules on the form and content of company financial statements and reports to a Standards Board, based on the present ASB but with a wider remit, and to extend the role of a Reporting Review Panel, based on the present Financial Reporting Review Panel (FRRP).

Increasingly, national standard setting is being superseded by regional and international standard setting and we examine this extremely important development in the following chapter.

## Introduction

In Chapter 1 we explained that there is no general theory of accounting in existence to guide us in the preparation of financial statements. We explored the attempts of several bodies to build conceptual frameworks of accounting and concentrated on the work of the ASB in developing its *Statement of Principles for Financial Reporting*. In spite of the lack of theory, there are many rules which govern the preparation of financial statements and in this chapter we turn to the framework for the setting and enforcement of such rules in the United Kingdom.

Rule setters affecting the United Kingdom come in three main forms, each of which has different powers and sanctions available to it:

- 1 *Government at both the United Kingdom and European Union levels.* These operate through legislation.
- 2 *Securities markets.* In the United Kingdom the Stock Exchange imposes rules which must be complied with by companies that have their shares and other securities traded on the Exchange.

3 *Standard setting bodies in the private sector.* In the United Kingdom, standard setting takes place nationally through the work of the ASB. The European Union Regulation which requires all European companies that have their shares publicly traded on securities markets in Member States to prepare their consolidated financial statements in accordance with International Accounting Standards by the year 2005<sup>1</sup> raises the status of those international standards as well as raising a number of questions about future relationships between national standard setters and the IASB, which we shall discuss in some depth in the following chapter.

We shall first examine each of the three sources of authority within the UK context before turning to the proposals in the Government White Paper, *Modernising Company Law*, published in July 2002.<sup>2</sup>

## Legislation

### Background

The advent of the limited liability company by registration under a general Act of Parliament in the mid-nineteenth century made possible the separation of management from ownership, which is such a dominant feature of business organisation today. With this separation came the need for directors to render accounts (financial statements, in modern terminology) to shareholders to show the performance and financial position of the company. It followed that it was necessary to determine what should be included in such accounts and how they should be prepared.

It would have been possible for the law to have left the specification of the form and content of such accounts to be determined by contract between the shareholders and directors, or even to have left the directors to decide what information should be made available in the particular circumstances. However, the law initially flirted with the regulation of accounting disclosure in the period 1844–56 and then became permanently involved with regulating the contents of company accounts early in the twentieth century. The Companies Act 1929 increased the information which companies had to disclose while extensive disclosure has been required since the Companies Act 1948.<sup>3</sup>

Before the Companies Act 1981, the accounting requirements of company law allowed companies considerable latitude. The directors were required to prepare accounts which showed a true and fair view and which contained the minimum information specified by the various Companies Acts. These accounts, together with the accompanying auditors' and directors' reports, had to be laid before the shareholders and filed with the Registrar of Companies within certain time limits. While the basic position is unchanged, substantial alterations were made by the Companies Act 1981.

<sup>1</sup> Regulation PE-CONS 3626/02, European Union, June 2002. See Chapter 3, Sources of authority: the rise of international standards

<sup>2</sup> *Modernising Company Law*, Cm. 5553–I and 5553–II, HMSO, July 2002. See also [www.europa.eu.int/comm.internal\\_market/en/company/account/news/index.htm](http://www.europa.eu.int/comm/internal_market/en/company/account/news/index.htm)

<sup>3</sup> Readers who wish to study this historical development of accounting further are referred to H.C. Edey, 'Company accounting in the nineteenth and twentieth centuries', in *The Evolution of Corporate Financial Reporting*, T.A. Lee and R.H. Parker (eds), Nelson, London, 1979, and J.R. Edwards, *A History of Financial Accounting*, Routledge, London, 1989: Chapters 9, 10 and 11 of the latter are particularly relevant.

The Companies Act 1981 was mainly concerned with the implementation of the EC Fourth Directive, a directive heavily influenced by the more prescriptive approach to accounting found in France and Germany. As a consequence, the Act was much more prescriptive than previous legislation in the UK. Although it still contained the overriding principle that accounts should give a true and fair view, it increased substantially the amount of information to be disclosed and reduced considerably the flexibility which companies previously enjoyed. Thus, whereas directors were previously able to choose the particular formats and valuation rules which seemed most appropriate in the circumstances, the Companies Act 1981 specified much more tightly the formats and valuation rules to be used.

The provisions of the Companies Act 1981 are now contained in the Companies Act 1985, which was a consolidating Act, but this in turn has been amended by the subsequent Companies Act 1989 and numerous Statutory Instruments.

The Companies Act 1989 implemented the EC Seventh Directive on consolidated accounts and the EC Eighth Directive on auditors, as well as dealing with many other matters.

Small and medium-sized companies have long enjoyed the opportunity of filing abbreviated accounts with the Registrar of Companies. However, as a consequence of the attempts of successive governments to reduce the burden of regulation on small companies, new rules were introduced in 1997 to reduce the volume of disclosure required of small companies and groups. The Companies Act 1985 (Accounts of Small and Medium-Sized Companies and Minor Accounting Amendments) Regulations 1997 (SI 1997/220) established a revised Schedule 8 to the 1985 Companies Act, which now contains all the provisions of the law relating to the accounts which small companies must send to their members. This law, together with the accounting standard *Financial Reporting Standard for Smaller Entities* (FRSSE) now provides a less burdensome regulatory framework for small companies and groups.<sup>4</sup>

In this book we shall concentrate on what is sometimes called ‘Big GAAP’, that is Generally Accepted Accounting Practice for large companies and groups. While we will from time to time draw attention to some of the exemptions available to small and, to a lesser extent, medium-sized companies and groups, we will not deal with these systematically or in any detail.

Concentrating now on large companies, the law requires that full accounts, including group accounts where appropriate, are sent to all shareholders and debenture holders of the company, although permission is given for a listed public company to send a summary financial statement to its shareholders.<sup>5</sup> The latter provision was intended to reduce the cost of sending full accounts to large numbers of relatively unsophisticated shareholders, particularly following the large privatisation issues of the 1980s. Full accounts have to be laid before the company in general meeting except that a private company may elect not to do so.<sup>6</sup> Such provisions are designed to ensure that shareholders and debenture holders receive financial information about companies, while recognising that it may not be necessary formally to present the accounts of a private company at a general meeting.

In addition to the above, companies are required to make their accounts available to the public by filing them with the Registrar of Companies within certain time limits, namely ten months after the end of the accounting year for a private company and seven months after the end of an accounting year for a public company.

<sup>4</sup> The first FRSSE was issued in November 1997 and updated versions have been issued in December 1998, December 1999 and December 2001. It is intended that the Standard be updated periodically to incorporate relevant parts of new FRSs and Abstracts of the Urgent Issues Task Force (UITF).

<sup>5</sup> Companies Act 1985, s. 251 (as inserted by the Companies Act 1989, s. 15). This section was implemented by the Companies (Summary Financial Statement) Regulations 1990, SI 1990/515. See Chapter 17, pp. 555–7

<sup>6</sup> Companies Act 1985, s. 252 (as inserted by the Companies Act 1989, s. 16).

## The current position

The Companies Act 1985, as amended by the Companies Act 1989, requires that the accounts of a large company give the information specified in Schedule 4 using one of the profit and loss account and balance sheet formats provided. However, compliance with this requirement is not sufficient to ensure compliance with the law for there is an overriding requirement that every balance sheet shall give a true and fair view of the state of affairs of the company and that every profit and loss account shall give a true and fair view of the profit or loss of the company for the financial year.<sup>7</sup>

Hence, having prepared the accounts containing the required disclosure, the accountant must then step back and decide whether or not the overall impression created is true and fair. If the accounts do not give such an impression, additional information must be provided. If the provision of additional information still does not result in a true and fair view, then the accounts must be changed, even if this means that they do not comply with the other statutory rules. Particulars of any departure, the reasons for it and its effect must be disclosed in the notes to the accounts.

The statutory requirements outlined above pose a number of problems for the accountant. Familiarity with the disclosure requirements of the Companies Acts is required, as is knowledge of the measurement or valuation rules to apply in arriving at the figures to be disclosed. Also the accountant must be aware of what is meant by the words 'true and fair'. We will look at each of these three aspects in turn.

The first problem involves detailed knowledge of the Companies Acts and the various guides thereto and considerable practice in applying those rules in various circumstances. We assume that readers have some knowledge of the requirements of the Companies Acts although, where relevant, we will reproduce the statutory rules in later chapters.

The second problem involves the selection of measurement or valuation rules to apply in arriving at the various figures which appear in the set of accounts. This requires a considerable knowledge of accounting, which this book will help to provide.

Until the Companies Act 1981 accountants would have looked to accounting principles, conventions, recommendations and standards to help them with this task. Although, as we shall see, such sources are extremely important, certain basic accounting principles have now been incorporated into the law. Thus, the law requires that accounts should be prepared in accordance with five accounting principles:

- 1 Going concern
- 2 Consistency
- 3 Prudence
- 4 Accruals
- 5 Separate determination of each asset and liability

Statute law now requires that these principles must be applied unless there are special reasons for departing from them. Where such special reasons exist, a note to the accounts must state the details of the departure, the reason for it and its effect.<sup>8</sup> We shall discuss the first four of these principles later in this chapter and the fifth principle in Chapter 9.

The Act provides that companies may prepare their accounts using either historical cost accounting rules or alternative accounting rules.<sup>9</sup>

<sup>7</sup> Companies Act 1985, s. 226.

<sup>8</sup> Companies Act 1985, Schedule 4, Part II, s. A, Paras 9–15.

<sup>9</sup> The historical cost accounting rules are contained in the Companies Act 1985, Schedule 4, s. B while the alternative accounting rules are contained in Schedule 4, s. C.

The alternative accounting rules are so framed to permit companies to use piecemeal revaluations in their historical cost accounts or to prepare current cost accounts as their main accounts, although in either case it is necessary to provide certain information to enable partial reconstruction of the historical cost accounts.

Some UK accountants are strongly opposed to the inclusion of such accounting principles and valuation rules in the law. They argue that it provides a straitjacket which may impede accounting development and two examples will illustrate their arguments.

First, company law includes a provision that ‘only profits realised at the balance sheet date shall be included in the profit and loss account’. For reasons which we explain in Chapter 4, the ASB has taken the wise decision that a poorly defined concept of realisation is an inappropriate criterion for determining whether or not gains or losses should be recognised in the financial statements. However, while it has been possible for the ASB to ignore this legal constraint in drafting its *Statement of Principles for Financial Reporting*, it is not possible to ignore it when drafting accounting standards. As a consequence, the ASB is hampered in its attempts to reform accounting practice by a poorly thought out and somewhat dated legal provision.

Second, the alternative accounting rules permit the preparation of current cost accounts as a company’s main accounts. As we explain in Part 3 of the book, Current Cost Accounting was very much in vogue in the 1970s and early 1980s, when the Companies Act 1981 was enacted. However, it is now very much out of favour and, to the best of our knowledge, no UK company now prepares its financial statements using current cost accounting. The statutory reference to current cost accounts now looks rather dated and out of line with the current approach of the ASB.

When accounts have been prepared, the accountant must decide whether they show a true and fair view and, if not, in what respects they need to be altered. These words ‘true and fair’ were first introduced together in the Companies Act 1948, following the recommendations of the Cohen Committee.<sup>10</sup> They have never been defined by statute but, rather, their meaning has become established by usage. A good definition has been provided by G.A. Lee:

Today, ‘the true and fair view’ has become a term of art. It is generally understood to mean a presentation of accounts, drawn up according to accepted accounting principles, using accurate figures as far as possible, and reasonable estimates otherwise; and arranging them so as to show, within the limits of current accounting practice, as objective a picture as possible, free from wilful bias, distortion, manipulation or concealment of material facts.<sup>11</sup>

So, in order to decide whether or not a set of accounts presents a true and fair view, it is necessary for the accountant to have recourse to a constantly changing body of accounting principles and standards.<sup>12</sup>

## Stock Exchange rules

Where companies have shares listed on the Stock Exchange or quoted on the Alternative Investment Market, they must comply with the additional disclosure requirements laid down by the Stock Exchange. These rules require the provision of both some more information and some more frequent information than that required by law.

<sup>10</sup> *Report of the Committee on Company Law Amendment*, Cmnd. 6659, HMSO, London, 1945.

<sup>11</sup> G.A. Lee, *Modern Financial Accounting*, 3rd edn, Nelson, London, 1981, p. 270.

<sup>12</sup> For a fuller discussion of the term ‘true and fair’ readers are referred to David Flint, *A True and Fair View in Company Accounts*, Gee and Co., London, 1982.

Examples of greater disclosure are the requirements for more detailed analysis of certain creditors, namely bank loans, overdrafts and other borrowings, in the annual financial statements, as well as the requirement for directors to disclose whether or not they have complied with the provisions of the *Combined Code on Corporate Governance*.<sup>13</sup>

The best example of the requirement for more frequent information is the requirement for quoted companies to prepare and publish an interim report, containing certain minimum information. This provides investors and other users with more timely information on which to base their decisions.

## Accounting concepts

We have seen how statute law requires companies to disclose a considerable amount of information and lays down broad principles which must usually be applied in arriving at the figures disclosed. We have also seen how this information is extended for companies subject to the rules of the Stock Exchange.

In order to prepare accounts complying with the law and, where appropriate, the Stock Exchange rules, an accountant must turn to what are referred to as generally accepted accounting principles, conventions or concepts. These were first developed during the latter part of the nineteenth century but have been the subject of continuous development as new situations have arisen and new ideas have emerged.

Many such principles could be listed, but a useful starting point would seem to be the fundamental accounting concepts of SSAP 2 *Disclosure of Accounting Policies*. SSAP 2 was originally issued in November 1971 but, as we shall see below, has now been replaced by FRS 18 *Accounting Policies*, issued in December 2000.

The fundamental accounting concepts of SSAP 2 were defined as ‘the broad basic assumptions which underlie the periodic financial accounts of business enterprises’.<sup>14</sup>

Four concepts were listed and these are the same as the first four principles listed in the Companies Act 1985 as shown above. Users of the accounts were entitled to assume that the concepts have been applied in the preparation of a set of accounts unless warning is given to the contrary.

The four concepts were as follows:

- 1 *Going concern*: Following the application of this concept, the accounts are drawn up on the basis that the enterprise will continue in operational existence for the foreseeable future. Thus, the accountant does not normally prepare the accounts to show what the various assets would realise on liquidation or on the assumption of a fundamental change in the nature of the business. It is assumed that the business will continue to do in the future the same sort of things that it has done in the past. If, of course, such continuation is not expected, then the going concern concept must not be applied. So if, for example, liquidation seems likely then the valuation of assets on the basis of sale values would be appropriate. The accountant must then give warning to the users that the usual going concern concept has not been applied.
- 2 *Accruals*: While this is an easy concept to describe and, indeed, to apply in situations that are commonly encountered, its implementation sometimes gives rise to problems.

<sup>13</sup> *Combined Code on Corporate Governance*, The London Stock Exchange Limited, London, 1998. This Code has been developed from the earlier Cadbury and Greenbury Reports.

<sup>14</sup> SSAP 2 *Disclosure of Accounting Policies*, Para. 14.

Revenues and costs are not calculated on the basis of cash received or paid. Revenues are recognised when they are earned, usually at the date of a transaction with a third party. Against such revenues are charged, not the expenditures of a particular period, but the costs of earning the revenue which has been recognised.

- 3 *Consistency*: The consistency concept requires like items to be treated in the same manner both within one set of accounts and from one period to another.

Such a concept could easily prevent progress if applied too rigidly for, if a better accounting treatment than the existing method was discovered, it could never be applied because it would be inconsistent with the past! Obviously, it will be necessary to depart from this concept on occasions but then it is necessary to give warning that such departure has occurred and to show clearly what the effect has been.

- 4 *Prudence*: This concept has specified that accountants do not take credit for revenue until it has been realised but that they do provide for all known liabilities. This asymmetrical approach was designed to introduce a bias that tended to understate profit and undervalue assets. Although such a concept might at first sight be thought to benefit users, it may instead damage their interests. Thus a shareholder may sell his or her shares at a low price because the financial statements show low profits and low asset values. As we have seen in Chapter 1, the ASB is attempting to refine the definition of the prudence concept along the following lines:<sup>15</sup>

Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that gains and assets are not overstated and losses and liabilities are not understated. In particular, under such conditions it requires more confirmatory evidence about the existence of, and a greater reliability of measurement for, assets and gains than is required for liabilities and losses.

FRS 18 *Accounting Policies* was issued in December 2000 to update SSAP 2 to bring it into line with the thinking contained in the *Statement of Principles*. The key provision of the standard is that:

An entity should adopt accounting policies that enable its financial statements to give a true and fair view. Those accounting policies should be consistent within the requirements of accounting standards, Urgent Issues Task Force (UITF) Abstracts and companies legislation.<sup>16</sup>

Under the terms of FRS 18, users may still assume that the going concern and accruals concepts have been applied, unless they are given clear warning to the contrary, but the roles of consistency and prudence have changed.

These last two concepts have disappeared. Instead, in line with the thinking of the *Statement of Principles*, the appropriateness of accounting policies should be judged against the following objectives:

- Relevance
- Reliability
- Comparability
- Understandability

<sup>15</sup> *Statement of Principles for Financial Reporting*, ASB, London, December 1999, Para. 3.19.

<sup>16</sup> FRS 18 *Accounting Policies*, Para. 14.

When judging the appropriateness of accounting policies, the entity needs to consider two constraints:

- The need to balance the above objectives.
- The need to balance the cost of providing information with the likely benefit to users of the financial statements.

The ASB did not find the distinction drawn by SSAP 2 between accounting bases and accounting policies to be of any value and does not use the former term. The new term now in use is *Estimation techniques*, which is defined as:

**the methods used by an entity to arrive at estimated monetary amounts, corresponding to the measurement basis selected for assets, liabilities, gains, losses and changes to shareholders' funds.<sup>17</sup>**

Estimation techniques thus include methods of depreciation and the bases for estimating the provision for doubtful debts. The standard includes an Appendix devoted to the distinction between changes in accounting policies and changes in estimation techniques which is important because, only changes in accounting policies give rise to a prior period adjustment under the provisions of FRS 3 *Reporting Financial Performance*.

Even where an accountant complies with FRS 18, he or she still has considerable flexibility in the way in which assets are valued and profit determined. There are, for example, many methods of depreciating fixed assets or of valuing stocks and work-in-progress; there are many ways of accounting for deferred taxation and for translating the accounts of overseas subsidiaries. From the numerous accounting methods available, an accountant must choose the appropriate policy to apply in the circumstances of the particular company.

As we have seen in Chapter 1, there are many different users of financial statements and their needs for information may conflict: in addition, as we have seen in this chapter, we have no precise idea of what is meant by the words 'true and fair'. Add to this the fact that the valuation of any asset or liability by its very nature, even under the historical cost system, involves taking a view of the future, and it is not surprising that different accountants will arrive at different views of the same business reality and hence report different figures.

## Recommendations and freedom of choice

In order to help their members to choose the appropriate accounting policies, the various professional bodies have issued recommendations on accounting principles. For example, the Institute of Chartered Accountants in England and Wales (ICAEW) issued 29 such recommendations between 1942 and 1969, and these provided guidance on all manner of accounting matters. These recommendations were persuasive rather than mandatory and often permitted a choice from various methods of accounting for a particular set of transactions.

Most accountants appreciated the freedom which these recommendations provided and perhaps welcomed, as a bonus, the fact that the existence of flexibility made it difficult for anyone to prove that mistakes had been made. However, many thoughtful accountants took a more principled position and argued that the complexities of business were such that it was not desirable, nor even possible, to specify in advance a set of accounting rules to be applied rigidly in all circumstances. They argued that there would always be occasions when any preordained rules would be inappropriate and that the benefits resulting from the

<sup>17</sup> FRS 18, Para. 4.

existence of flexibility, in terms of meaningful reporting on such occasions, more than outweighed the disadvantage that equally competent accountants might produce different results in the same circumstances.

A number of incidents in the late 1960s brought the existence of such flexibility to the attention of the general public and in 1968 Sir Frank Kearton, Chairman of Courtaulds and the Industrial Reorganisation Corporation, wrote to the President of the ICAEW to complain about ‘the plethora of generally accepted accounting principles’. The problem was brought to a head in 1968 in connection with the GEC/AEI and Pergamon/Leasco affairs.<sup>18</sup>

In 1969 the late Professor Edward Stamp wrote a letter to *The Times* in which he was very critical of some aspects of the accountancy profession, in particular its lack of independence and its lack of a theoretical foundation for the preparation of accounts. His letter provoked an angry reaction from the accountancy profession in the person of Ronald Leach, President of the ICAEW. Suffice it to say that the criticism and ensuing debate led to the issue of a ‘Statement of intent on accounting standards in the 1970s’ by the ICAEW in 1969 and to the subsequent formation of the Accounting Standards Steering Committee.

## Standardisation

### From 1970 to 1990

The ‘Statement of intent on accounting standards in the 1970s’ issued by the Council of the ICAEW in 1969 set out a plan to advance accounting standards along the following lines:

- (a) narrowing the areas of differences and variety in accounting practice;
- (b) disclosure of accounting bases;
- (c) disclosure of departures from established definitive accounting standards;
- (d) wider exposure for major new proposals on accounting standards;
- (e) a continuing programme for encouraging improved standards in legal and regulatory matters.

To this end, an Accounting Standards Steering Committee was set up by the ICAEW, the ICAS and the Institute of Chartered Accountants in Ireland. The Committee was later joined by representatives of the Association of Certified Accountants (now the Association of Chartered Certified Accountants – ACCA) and the Institute of Cost and Management Accountants (now the Chartered Institute of Management Accountants – CIMA) in 1971 and by representatives of the Chartered Institute of Public Finance and Accountancy (CIPFA) in 1976. From 1 February 1976 its name was changed to the Accounting Standards Committee (ASC) and it was reconstituted as a joint committee of the six member bodies acting through the Consultative Committee of Accountancy Bodies (CCAB).

Until 1982, the ASC consisted of more than 20 members, all of whom were qualified accountants. Membership of the committee was part-time and unpaid. The ASC had no power to issue standards in its own right but, once a standard had been set by the committee and approved and issued by the councils of the six CCAB members, individual members of the various professional accountancy bodies were required to comply with the standard. Thus, we had a body of professional accountants imposing rules above those required by the law of the land and attempting to enforce them through the constituent member bodies. Such a process was criticised on two counts.

<sup>18</sup> These are dealt with in E. Stamp and C. Marley, *Accounting Principles and the City Code: the Case for Reform*, Butterworths, London, 1970.

First, the people who can be expected to benefit from standards are the users of accounts. If such is the case, then it may be argued that these users should have a larger say in the formulation of standards. Indeed, accounting standards may have considerable impact on economic behaviour which some would argue should, in a democratic state, be taken into consideration by duly elected Members of Parliament.<sup>19</sup> To give an example, FRS 17 *Retirement Benefits*, issued in November 2000, proposed that any deficit in a company pension scheme should be recognised as an expense in the company's profit and loss account. Even before this standard was fully implemented, it contributed to the decisions of many large companies to close their defined benefit pension schemes to new members and this will have severe consequences for the welfare of large sections of the population. We will return to this topic in Chapter 10.

Second, for standards to be effective, it is essential that they are enforced. However, the law places the onus for preparing accounts clearly on the shoulders of directors, and professional accountancy bodies have no authority over such directors unless the directors happen to be professional accountants.<sup>20</sup> Even where professional accountants are involved, the ultimate penalty for non-compliance was disciplinary action against those members, and the professional bodies appear to have been loath to take such action.

The ASC was aware of these and other criticisms and a number of changes were made as a result of two papers: *Setting accounting standards: a consultative document*, known colloquially as the Watts Report after the then chairman of the ASC, Mr Tom Watts, published in 1978, and *Review of the standard setting process*, known as the McKinnon Report after its chairman, published in 1983.

As a consequence of these reports, membership of the ASC was opened up to include non-accountants representing user groups, and some new types of pronouncement were introduced. However, the Watts Report's recommendation that a panel be established to review non-compliance with accounting standards by listed companies was not acted upon at that time.

The 1983 Review introduced the publication of two new types of statement, the Statement of Intent (SOI) and the Statement of Recommended Accounting Practice (SORP). While the SOI, a short public statement explaining how the ASC proposed to deal with a particular accounting matter, was used very rarely, the SORP was a completely different type of statement issued on topics considered not to be of sufficient importance to warrant the issue of an accounting standard. These non-mandatory SORPs hark back to the earlier recommendations of the professional accountancy bodies. It was intended that such statements would be issued for matters which are of widespread application but not of fundamental importance, or for matters which are of limited application, in specific industries or particular areas of the public sector. In the case of statements of limited application, SORPs were prepared by the specific industry or areas of the public sector and then 'franked', that is approved, by the ASC.<sup>21</sup>

In spite of the changes which were made, the ASC came under increasing criticism in the 1980s. Its lack of powers of enforcement became blatantly obvious in the context of SSAP 16 *Current Cost Accounting*, when at one time only some 25 per cent of the companies to which it applied were actually complying with its provisions. In addition, the ASC faced enormous

<sup>19</sup> For an account of the effect of standard setting on economic behaviour see S.A. Zeff, "The rise of "economic consequences", *Journal of Accountancy*, December 1978.

<sup>20</sup> The so-called accounting scandals that emerged in the USA in 2001 and 2002 have provided an impetus for governments, not just in the USA, to produce tougher legislation to punish directors who connive in the production of misleading financial statements.

<sup>21</sup> An example of the first type of SORP is *Accounting for Charities*, issued in May 1988. Some examples of franked SORPs are those issued by the Oil Industry Accounting Committee and the Committee of Vice-Chancellors and Principals of the Universities of the United Kingdom.

difficulties in developing standard practice for controversial areas such as accounting for business combinations and intangible assets.

A decline in the credibility of the ASC led to the establishment of the Dearing Committee, named after its chairman, now Lord Dearing, which produced its report, *The Making of Accounting Standards* (the Dearing Report), in September 1988. This, in turn, has led to fundamental changes in the process of setting and enforcing accounting standards in the United Kingdom.

## The current regime – structure

The Dearing Report took the view that standards should no longer be set by an inadequately financed ASC made up of part-time unpaid members, with only a small technical staff, and with no powers of ensuring compliance with its standards. It therefore recommended major changes.

In the view of the Dearing Report, effective standard setting required considerably more resources than had been available in the past. Given that a large constituency of users benefit from the existence of accounting standards, it was thought to be unreasonable for the process of standard setting to be financed wholly by the accountancy profession. Dearing therefore recommended a large increase in the finance available and a sharing out of the cost of standard setting.<sup>22</sup>

As a consequence of the Dearing Report, a Financial Reporting Council, drawn from a wide constituency of interests, was set up to guide the standard setting process and to ensure that it is properly financed. Standards are now set by the Accounting Standards Board (ASB), which has the power to issue standards in its own right. In addition, a Financial Reporting Review Panel (FRRP) was established to examine contentious departures from accounting standards by large companies.

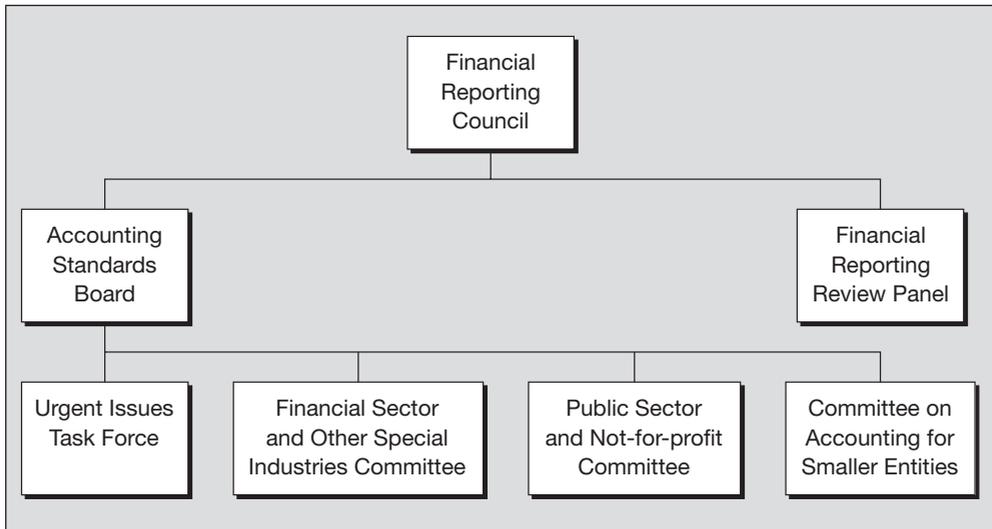
An Urgent Issues Task Force (UITF) has also been set up as a committee of the ASB to provide timely and authoritative interpretations on the application of standards. In addition, there are three more specialised committees which support the work of the ASB. These are the Financial Sector and Other Special Industries Committee, the Public Sector and Not-for-Profit Committee and the Committee on Accounting for Smaller Entities (CASE). As a consequence, the present structure is as shown in Figure 2.1 on p. 34.

The ASB is a much smaller body than its predecessor. It consists of not more than nine members with a full-time Chairman and Technical Director, supported by a much larger technical and administrative staff to permit a higher level of research. As recommended by the Dearing Report, it has the power to issue standards in its own right and, for this, a two-thirds majority is required.

The introduction of the FRRP was more revolutionary, although the establishment of such a body had been proposed in the Watts Report in 1978. It is a panel of some twenty members chaired by a QC. The function of the Review Panel is to examine the accounts of large companies to ensure that they give a true and fair view and comply with the Companies Act 1985 and applicable accounting standards.

Although the government chose not to give statutory backing to accounting standards, it introduced provisions which facilitate the operations of the Review Panel. The first of these is a requirement for directors of all large (but not small or medium-sized) companies to state in the notes to the accounts whether or not those accounts have been prepared in accordance

<sup>22</sup> The operating cost of the present regime, which amounted to some £2 769 000 in the year to 31 March 2002, comes from three main sources: the accountancy profession, government and city institutions, which include the Financial Services Authority. A substantial sum is also raised by the sale of ASB publications and from interest receivable.



**Figure 2.1 Structure of the organisation for setting and enforcing accounting standards**

with applicable accounting standards, drawing attention to material departures and explaining the reasons for them.<sup>23</sup> The second is the introduction of procedures for the revision of accounts which are considered to be defective. These include a procedure whereby accounts can be revised voluntarily by the directors and a procedure whereby the Secretary of State for Trade and Industry or other authorised persons are able to apply to the court for an order requiring the revision of a company's accounts.<sup>24</sup> The FRRP is an 'authorised person' under these provisions and concentrates on the accounts of public and large private companies.

## The current regime – progress

One of the many problems which confronted the ASB, and indeed the ASC before it, was the lack of a conceptual framework for accounting. As we have discussed in Chapter 1, the ASB immediately set to work to build such a framework and eventually published an exposure draft of its *Statement of Principles for Financial Reporting* in November 1995. Following a hostile reaction to that draft, it was withdrawn and a revised exposure draft was issued in March 1999. The *Statement of Principles* was published shortly afterwards in December 1999.

While some people might argue that no standards should have been set until the *Statement of Principles* had been finalised, it would have been quite impossible for the ASB to adopt such an approach. Indeed, it is becoming more widely recognised that the search for one conceptual framework is a search for the Holy Grail. Given the multiple users of accounts, there are probably many different conceptual frameworks, with a consequent implication for the adoption of multicolumn reporting.<sup>25</sup> If such is the case then we should not be under any illusion that the *Statement of Principles* will solve all the problems of accounting although, of course, it may enable us to remove some of the many inconsistencies which exist at present.

<sup>23</sup> Companies Act 1985, Schedule 4, Part III, Para. 36A.

<sup>24</sup> These provisions are contained in the Companies Act 1985, s. 245.

<sup>25</sup> See Chapter 21.

While work proceeded on the development of the *Statement of Principles*, the ASB continued its work on standard setting. In its first 13 years of operation, it has produced an enormous volume of regulation in the form of Financial Reporting Standards (FRSs), which we have listed in Table 2.1.<sup>26</sup>

**Table 2.1 Financial Reporting Standards issued by ASB, 1990–2002**

1	Cash Flow Statements	1991, revised 1996
2	Accounting for Subsidiary Undertakings	1992
3	Reporting Financial Performance	1992, amended 1993
4	Capital Instruments	1993
5	Reporting the Substance of Transactions	1994, amended 1994
6	Acquisitions and Mergers	1994
7	Fair Values in Acquisition Accounting	1994
8	Related Party Disclosures	1995
9	Associates and Joint Ventures	1997
10	Goodwill and Intangible Assets	1997
11	Impairment of Fixed Assets and Goodwill	1998
12	Provisions, Contingent Liabilities and Contingent Assets	1998
13	Derivatives and other Financial Instruments: Disclosures	1998
14	Earnings per Share	1998
15	Tangible Fixed Assets	1999
16	Current Tax	1999
17	Retirement Benefits	2000
18	Accounting Policies	2000
19	Deferred Tax	2000

These standards have changed the face of financial reporting considerably. FRS 3 *Reporting Financial Performance*, in particular, changed the presentation of the profit and loss account and introduced the new primary statement, the Statement of Total Recognised Gains and Losses. As we shall see in Chapter 11, the pace of change is now so fast that this standard is itself already under review.<sup>27</sup> Other standards, such as FRS 4, FRS 5 and FRS 12 have addressed areas in which major abuses had occurred in the past. Yet other standards have tackled fundamental and difficult areas of accounting such as what to do with the large amounts paid for goodwill and intangible assets in an age when such assets may be far more important than tangible assets. One of the more difficult and controversial topics still on the agenda of the ASB is the measurement of derivatives and other financial instruments. We will, of course, deal with all of these topics later in this book.

<sup>26</sup> On its formation, the ASB adopted a large number of Statements of Standard Accounting Practice (SSAPs) published by its predecessor and many of these are still in force. Examples are SSAP 9 *Stocks and Long-term Contracts* and SSAP 20 *Foreign Currency Translation* although both of these are under review in 2002/2003 as part of the convergence project to bring national and international standards into line with one another.

<sup>27</sup> See Discussion Paper, *Reporting Financial Performance: Proposals for Change*, ASB, London, June 1999, and FRED 22 *Revision of FRS 3 'Reporting Financial Performance'*, ASB, December 2000.

While the ASB has been working on the above and many other issues, the UITF has been providing timely guidance on contemporary accounting problems. Its guidance is provided in the form of Abstracts and, by the end of 2002, it had issued 35 such Abstracts.<sup>28</sup>

The FRRP does not systematically examine the accounts of all the companies within its ambit. Rather it acts only when something which appears to be wrong is drawn to its attention. Its references come from three broad sources: qualified audit reports or recorded non-compliance, cases referred by individuals or corporate bodies, and press comment.

Some of these references are not pursued beyond an initial examination but most have been pursued with the directors concerned. The Review Panel has not as yet considered it necessary to apply for a court order for rectification of accounts, although a fund of £2m is available to finance such action. In cases where companies have been found to be at fault, the Panel has been able to reach voluntary agreement with the directors concerned, usually requiring them to rectify errors in the next set of accounts or interim statement.

During 2001, the accounts of 53 companies were brought to the attention of the Panel.<sup>29</sup> This is an increase over the previous year but represents a significant decrease compared with references in earlier years of the Panel's existence. During the year, 27 cases were concluded and seven press notices were issued.

There appears to be widespread approval of the work and operations of the FRRP and it is now seen as a possible role model by other countries.

## Advantages and disadvantages of standardisation

Before we consider the proposals of the Government White Paper, *Modernising Company Law*, it is perhaps helpful if we review both the advantages and the disadvantages of standardising accounting practice, for the process of standardisation is not without its critics.

Accounting may be described as the language of business. As with any communication, it is important that the preparers of a document and the users adopt the same language. Standards may be regarded as the generally accepted language.

As recent accounting scandals have made very clear, when directors prepare accounts for their companies, they are unlikely to be indifferent to the position shown by those accounts. If there are many generally accepted accounting bases in existence, the choice of a particular policy may not be free from bias. The establishment of accounting standards, with the consequent need to justify departures from them, limits the possibility of exercising such bias and strengthens the hands of the auditor.

It is also clear that the process of setting standards, that is the issue of discussion papers, exposure drafts and standards, provokes considerable thought and discussion among members of the accounting profession. Although this has done much to make accounting an exciting area of study, most thoughtful accountants would probably now agree that one can have too much of a good thing!

<sup>28</sup> Some examples of the topics covered are:

UITF Abstract 6 'Accounting for post-retirement benefits other than pensions', November 1992,

UITF Abstract 9 'Accounting for operations in hyper-inflationary economies', June 1993,

UITF Abstract 29 'Website development costs', February 2001 and

UITF Abstract 33 'Obligations in capital instruments', February 2002.

<sup>29</sup> *2001 Annual Review*, Financial Reporting Council: Report by Chairman of the Financial Reporting Review Panel, p. 56, Para. 4.

One of the most pertinent criticisms of the process of standardisation was made by Professor W.T. Baxter writing about recommendations on accounting principles in 1953,<sup>30</sup> long before the Accounting Standards Steering Committee was formed. He argued that authoritative backing for one particular accounting treatment may have adverse effects. Although it may help practical men [and women] in their day-to-day work, in the longer run it may hinder experimentation and progress. An accountant or auditor may become loath to depart from a particular recommendation or standard and the educational process may become one of learning rules rather than searching for theories or truth. Indeed he argued that, if truth subsequently shows a recommendation or standard to have been wrong, then it may be hard for authoritative bodies to admit that they were wrong.

Both the ASC and the ASB have been well aware of these criticisms. Thus the *Foreword to accounting standards*, issued by the ASB in June 1993, makes it quite clear that the requirement to give a true and fair view may in exceptional circumstances require a departure from accounting standards and permits such a departure, although particulars of the departure, the reasons for it and its financial effects must then be disclosed in the financial statements (Paras 18 and 19). It also recognises that the standards are not absolute but will require amendment as the business environment and accounting thought evolves (Para. 33). As we shall see later in the book, there have been many cases where standards have been revised and these have often involved substantial changes in required standard accounting practice.<sup>31</sup> The standard setters certainly do not hesitate to recognise that previous standards may have been, or have become, deficient.

## The Government's proposals

British company law has developed since the mid-nineteenth century and has been added to in a piecemeal fashion, by both statute and case law, for well over a century. It is now bulky and complex and widely recognised to be in need of reform. To this end, the Government launched a Company Law Review in 1998 and, after much consultation, the Company Law Review Steering Group issued its final report, 'Modern Company Law For a Competitive Economy', in June 2001.<sup>32</sup> The Government considered this final report and, in July 2002, it issued a White Paper, *Modernising Company Law* setting out its proposals.<sup>33</sup>

The White Paper makes many proposals concerned with simplifying the formation and operation of companies, particularly small companies, in order to encourage enterprise. Here, we will concentrate on its proposals for reporting by limited companies and for the setting of rules for reporting by companies in future.

<sup>30</sup> W.T. Baxter, 'Recommendations on accounting theory', in *Studies in Accounting Theory*, 2nd edn, W.T. Baxter and S. Davidson (eds), Sweet & Maxwell, London, 1962, pp. 414–27. See also D.R. Myddelton, *Accountants Without Standards? – Compulsion or Evolution in Company Accounting*, IEA Hobart Paper 128, IEA, London, 1995.

<sup>31</sup> One example of such a change is the replacement of SSAP 22 *Accounting for Goodwill* by FRS 10 *Goodwill and Intangible Assets*. As we shall see in Chapter 13, the latter takes a fundamentally different approach to that of SSAP 22.

<sup>32</sup> Company Law Review Steering Group, 'Modern Company Law For a Competitive Economy', Final Report, Vols I and II, June 2001. This report, together with earlier publications of the Steering Group are available on [www.dti.gov.uk/cld/reviews/condocs.htm](http://www.dti.gov.uk/cld/reviews/condocs.htm).

<sup>33</sup> *Modernising Company Law*, Cm. 5553–I and 5553–II, HMSO, July 2002. Volume II contains some Draft Clauses of a proposed Companies Bill. Both volumes are available on [www.dti.gov.uk/companiesbill](http://www.dti.gov.uk/companiesbill).

The White Paper envisages that the present requirement for companies to prepare a directors' report will be abolished and that companies will be required to publish the following documents each year:

- Financial Statements. The exact nature of these is not specified but they are expected to include a balance sheet, a single performance statement and a cash flow statement as well as consolidated financial statements where appropriate.
- Supplementary Statement. This would replace the directors' report for most companies.
- For the most economically significant companies only, an Operating and Financial Review. The White Paper envisages that this requirement will apply to about a thousand companies or groups and specifies possible criteria for identifying these.<sup>34</sup>
- For quoted companies only, a Directors' Remuneration Report.
- An optional Summary Statement. It is envisaged that all companies, not just listed companies as at present, will be able to publish a Summary Statement, although shareholders will be given the right to receive the full reports if they so wish.

It is proposed that small and medium-sized companies should no longer be able to file abbreviated financial statements with Companies House and that the deadlines for filing annual reporting documents with the Registrar of Companies will be reduced for both public and private companies to six and seven months respectively after the year end. It is also proposed that quoted companies will have to publish their annual reporting documents on the internet within four months of their year ends.

Much detail still needs to be filled in as the Companies Bill develops but the way in which the Government intends to implement the detailed rules makes the proposals of the White Paper quite revolutionary. The Government recognises that it is difficult for the law to respond quickly to a rapidly changing business world or to changes in accounting thought. It is clearly concerned at the rather uncomfortable current mix of regulation by company law and accounting standards, with its resulting inconsistencies and overlaps. It therefore follows the recommendations of the Steering Group by proposing that, while a future Companies Act will specify the documents required of each type of company, it will delegate the setting of rules on the form and content of company financial statements to a Standards Board, the precise name of which would have to be decided but which would be based upon the present ASB. It envisages that this new Standards Board will have a wider remit than the present ASB and that, in particular, it will have responsibility for specifying the detailed content of both the Operating and Financial Review and the Summary Statement and possibly some responsibility for keeping the Combined Code under review. This would give much greater power and responsibility to the Standards Board.

The White Paper envisages that the law and standards would be enforced as at present by a Reporting Review Panel, for larger companies, and the Secretary of State, for smaller companies. Although the Reporting Review Panel would be based on the present FRRP, the Government suggests a change of name to reflect a widening responsibility for all the annual reporting documents of a company, not just its financial statements.

The proposed approach would seem likely to be much more responsive to changes in the world of business and accounting thought. However it gives considerable power to private-sector bodies, the members of which have not been elected and who are therefore not democratically accountable. As we shall see in the next chapter, the authority for rule making, for quoted companies at least, is moving away from the national standards setters to the IASB. In this context, the proposed approach of the government White Paper appears to be rather insular. It is to international and regional standardisation that we turn in the next chapter.

<sup>34</sup> Interested readers are referred to *Modernising Company Law*, Volume I, Part 4, paras 4.35 to 4.39.

## Summary

In this chapter, we have examined the regulatory framework of accounting in the UK. Thus we have examined company law, the Stock Exchange rules and accounting standards. We have seen how accounting standards grew out of the earlier recommendations of professional accountancy bodies and have examined how the Accounting Standards Committee operated from 1970 to 1990. We have explained why the ASC was replaced by the Accounting Standards Board in 1990 and examined how the ASB operates, supported by a number of sub-committees, including the Urgent Issues Task Force, and the Financial Reporting Review Panel. We have also examined the fundamental accounting concepts laid down in SSAP 2 and later in company law and shown how these have been modified by the provisions of FRS 18.

The Government launched a major company law review in 1998 and published a White Paper in July 2002. We have examined the main relevant proposals of this White Paper, in particular the proposed change to the way in which accounting rules are set. The White Paper envisages that the next Companies Act will delegate the power to set the rules on the form and content of company financial statements and other reports to a new Standards Board, based on the present ASB but with a wider remit. It also proposes the establishment of a Reporting Review Panel based on the present FRRP but again with a wider remit. It remains to be seen whether these proposals will be enacted and, if so, how they will interact with developments in the international arena to which we turn in the next chapter.

## Recommended reading

- W.T. Baxter, 'Accounting standards – boon or curse?', *Accounting and Business Research*, ICAEW, Winter 1981.
- M. Bromwich, *The Economics of Accounting Standard Setting*, Prentice Hall, London, 1985.
- R. Leach and E. Stamp (eds), *British Accounting Standards: The First Ten Years*, Woodhead-Faulkner, Cambridge, 1981.
- The Making of Accounting Standards* (The Dearing Report), ICAEW, London, 1988.
- D.R. Myddelton, 'Accountants Without Standards? – Compulsion or Evolution in Company Accounting', IEA Hobart Paper 128, IEA, London, 1995.
- G. Whittington, 'Accounting standards: A mixed blessing?', in *Essays in accounting thought: A tribute to W.T. Baxter*, I. Lapsley (ed.), ICAS, Edinburgh, 1996.

## Some useful websites

- [www.asb.org.uk](http://www.asb.org.uk)  
[www.dti.gov.uk/companiesbill](http://www.dti.gov.uk/companiesbill)  
[www.dti.gov.uk/cld/reviews/condocs.htm](http://www.dti.gov.uk/cld/reviews/condocs.htm)

## Questions

- 2.1** Your managing director has approached you saying that he is ‘confused at all the different accounting bodies that have replaced the old Accounting Standards Committee’.

You are required to draft a memorandum to your managing director explaining the purpose, a description of the type of work and, where applicable, examples of the work to date of the following:

- (a) Financial Reporting Council (3 marks)
- (b) Accounting Standards Board (4 marks)
- (c) Financial Reporting Review Panel (5 marks)
- (d) Urgent Issues Task Force (3 marks)

*CIMA, Advanced Financial Accounting, May 1993* (15 marks)

- 2.2** Before the introduction of accounting standards, accounting practices varied from enterprise to enterprise – there was inconsistency and occasionally practices were inappropriate. Intercompany and inter-period comparisons were difficult as enterprises changed accounting policies and resorted to, for example, ‘window-dressing’ and ‘reserve accounting’.

Discuss the extent to which the publication of more than 20 accounting standards has overcome these problems. Illustrate your discussion by reference to specific accounting standards.

*ICAEW, Financial Accounting 2, July 1993* (12 marks)

- 2.3** ‘At their simplest, accounts comprise a summary of cash receipts and payments. Concepts such as accruals and substance over form lead to increased complexity and may make it difficult for a user to interpret the results and financial position of a company. The key focus of future accounting standards and legislation should be simplification, not increased disclosure and more complex rules.’

Using examples, illustrate the complexities which may make it difficult for the various users to understand published accounts. Comment on any recent action taken by the Accounting Standards Board or the Government which has affected the complexity of accounts and discuss, reaching a conclusion, whether simplification of company accounts should be a key objective for the Accounting Standards Board and the Department of Trade and Industry.

*ICAEW, Auditing and Financial Reporting, final exam, July 1996* (12 marks)

- 2.4** The following is an extract from a press note published by the Financial Reporting Review Panel (FRRP):

FINDINGS OF THE FINANCIAL REPORTING REVIEW PANEL IN RESPECT OF THE ACCOUNTS OF S PLC FOR THE YEAR ENDED 31 MARCH 2001

The Financial Reporting Review Panel has had under consideration the Report and Accounts of S plc for the year ended 31 March 2001 and has discussed them with the company’s directors.

The matters raised by the Panel related to aspects of the company’s implementation of Financial Reporting Standard (FRS) 15 – *Tangible Fixed Assets*, regarded as standard in respect of financial statements relating to accounting periods ending on or after 23 March 2000.

The company's stated accounting policy in respect of properties was not to provide any depreciation on any given property until approximately ten years before the end of its useful life, from which point the depreciable amount was written off over the remainder of the useful life. In respect of plant and equipment, it was the company's policy not to commence depreciation until the accounting year following that in which the assets were acquired. In the Panel's view, neither of these policies complied with the requirements of FRS 15.

As reported in their Report and Accounts for the year ended 31 March 2002, the directors have accepted the Panel's findings. The directors have amended the 2001 comparative figures by way of prior year adjustment.

**Required:**

- (a) Explain the role of the Financial Reporting Review Panel (FRRP). (8 marks)
  - (b) Explain why the FRRP disagreed with S plc's depreciation policies and explain why it made this disagreement public. (6 marks)
  - (c) Explain whether the FRRP's role could be left to the external auditor. (6 marks)
- CIMA, Financial Accounting – UK Accounting Standards, May 2002* (20 marks)