

## Chapter 14

# Reporting corporate performance

### REAL WORLD CASE

#### Stakeholder engagement: key lessons

Vodafone touches a huge number of people across the markets in which it operates. The nature of these relationships differs. At 31 March 2005, we had over one million shareholders and 60,000 employees who were directly impacted by our business performance. Our 155 million customers relate to us as a service provider. Many more in local communities see our network infrastructure and some have strong views about it.

We want to understand the views of a wide range of stakeholders and to have an opportunity to explain our perspectives. We also aim to build mutual trust in the relationships we have with stakeholders. We know that we will not satisfy everyone's demands and believe that being open, honest and respectful of different views is the right approach.

#### How we engage

Stakeholder engagement takes many forms, formal and informal. It ranges from one-to-one meetings with an investor or pressure group to quantitative opinion research involving thousands of members of the public. It takes place at Group level and through our operating companies.

Part of our engagement is to be an active member of a range of CR organisations including the World Business Council for Sustainable Development (WBCSD), Forum for the Future, the Global e-Sustainability Initiative (GeSI), International Business Leaders Forum (IBLF) and Business in the Community (BiTC).

We record what we have learned from our many different interactions and assess the significance to our business of the various issues raised. Individual issues are prioritised according to their potential impact on the Group and our stakeholders, now and in the future.



#### Performance and data summary

|  | 2004/05 | 2003/04 | 2002/03 |
|--|---------|---------|---------|
| <b>Environment</b>   |         |         |         |
| Number of base stations  | 97,787  | 90,000  | 73,000  |
| Number of mobile phones collected (million)  | 1.27    | 1.29    | 1.14    |
| Proportion of mobile phones reused(%)  | 37      | 18      | 20      |
| CO <sub>2</sub> emissions from network operations and offices (millions of tonnes) (direct and indirect) | 1.2     | 1.1     | 1.0     |
| CO <sub>2</sub> emissions from company vehicles (tonnes)   | 56,000  | 49,000  | 58,000  |
| Proportion of network equipment waste reused and recycled (%)  | 96      | 86      | 76      |
| Paper purchased with a recycled content greater than 70% (%)   | 50      | 31      | 23      |

Source: Vodafone Group plc, Corporate Responsibility Report 2004/5, pp. 4, 35.

#### Discussion points

- 1 How does the company engage with stakeholders?
- 2 How would the 'Environment' information be viewed by different stakeholders?

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## Learning outcomes

After reading this chapter you should be able to:

- Explain the importance of the operating and financial review as a component of the annual report of a company.
- Describe and explain other useful information in the annual report that is relevant to analysis of corporate performance.
- Relate the interpretation of ratios to the information in a cash flow statement.
- Explain how segmental information is useful to the analysis of corporate performance.

## 14.1 Introduction

You have learned from Chapter 13 the basic techniques of ratio analysis that may help you to interpret the performance of a company relative to other companies or other periods of time. You have also learned how the ratios may be linked to the cash flow statement to interpret the factors affecting cash flow. It might be helpful to users of annual reports if companies themselves would carry out some analysis and interpretation of this type. There was a time when it was felt that the role of the company should stop at the presentation of the financial statements. Today, however, there is an expectation that companies will recognise the need to give more information to users, such as an objective discussion, called the **operating and financial review (OFR)** to be included in the annual report, plus other guidance such as highlights statements and trends of data. Most large companies report group accounts which, as explained in Chapter 7, are quite complex. Because of this complexity, analysts like to receive segmental information that breaks the total information into key areas of activity of the business. Some companies have sought to avoid disclosing all their activities in group accounts by use of 'off-balance sheet finance'. Because this omission may distort the view of performance, the standard setters have tried to restrict the use of off-balance sheet finance and encourage full reporting of group activities.

Beyond the responsibility for financial performance, the managers of companies have a responsibility and accountability to society in terms of their social and environmental activities. They are expected to demonstrate accountability by reporting on social and environmental activity in the annual report. The managers are also expected to follow best practice in the way they operate their business and in their relations with shareholders. This is described as corporate governance and the compliance with good practice in corporate governance must also be explained in the annual report.

Finally this chapter gives a taste of three areas of debate that extend beyond a first level course in accounting but which help the student to be aware that studying accounting should include a questioning and thoughtful approach to what is being learned. These three areas of debate are: the meaning of 'true and fair'; the nature of value; and the relevance of the stakeholder model.

## 14.2 Operating and Financial Review (OFR)

### 14.2.1 Development of the OFR

The operating and financial review (OFR) has been a feature of the annual reports of many listed companies since 1993.<sup>1</sup> It was created by the UK ASB as a move towards

providing shareholders with information on a company's performance and prospects. The ASB received encouragement from the Cadbury Committee in its 1992 report on the financial aspects of corporate governance. From 1993 to 2005 the provision of an OFR was voluntary. The ASB hoped that giving companies wide discretion would encourage the development of best practice in reporting rather than a slavish adherence to rules which might result in a lacklustre document. Most larger listed companies published an OFR in the annual report. In 2005 it became a legal requirement for all large companies to provide an OFR but was repealed in 2006.

The government took action to make the OFR a legal requirement following the recommendations of the Company Law Review which began in 1998 and was completed in 2001 (see section 4.5.2). Following the final publication from this Review, the government set a general framework of an OFR in legislation<sup>2</sup> and then delegated to the UK ASB the responsibility to provide detailed guidance. The government also had regard to the Accounts Modernisation Directive from the European Union (EU) which sets out requirements for an enhanced review of a company's business in the report from the directors.

It was intended that the OFR would be mandatory for all UK quoted companies reporting in or after 2006. However in late November 2005 the Chancellor of the Exchequer made a surprise announcement in a speech to the Confederation of British Industry announcing immediate abolition of this mandatory requirement. His reason was that the legislation added more than the minimum requirements of the relevant EU Directive (referred to as 'gold plating' the regulation) and was therefore burdening industry unnecessarily. It did appear that the OFR was a somewhat strange target for reducing regulation because users of annual reports find it useful and it is a location for reporting on the activities carried out by companies that harmonise with government policy on social issues. There is also a strong movement towards more narrative discussion in annual reports, as explained later in this chapter.

The guidance provided by the UK ASB is contained in *Reporting Standard 1 (RS 1): Operating and Financial Review*.<sup>3</sup> The Financial Reporting Council has indicated a desire to maintain RSI as good practice.

The objective of the OFR is to provide a balanced and comprehensive analysis, consistent with the size and complexity of the business, of:<sup>4</sup>

- (a) the development and performance of the business of the entity during the financial year;
- (b) the position of the entity at the end of the financial year;
- (c) the main trends and factors underlying the development, performance and position of the business of the entity during the financial year; and
- (d) the main trends and factors which are likely to affect the entity's future development, performance and position, prepared so as to assist members to assess the strategies adopted by the entity and the potential for those strategies to succeed.

The objective mentions only 'members' of the company, which means the existing shareholders. Earlier drafts of the reporting standard attempted to widen the objective to include intending investors but this was criticised as being too wide-ranging. There is no mention of any other stakeholders. (Look back to Chapter 1 for the potential range of interested parties.)

### 14.2.2 Principles

The ASB sets out seven principles<sup>5</sup> followed by a disclosure framework.

- 1 The OFR shall set out an analysis of the business through the eyes of the board of directors.

- 2 The OFR shall focus on matters that are relevant to the interests of members.
- 3 The OFR shall have a forward-looking orientation, identifying those trends and factors relevant to the members' assessment of the current and future performance of the business and the progress towards the achievement of long-term business objectives.
- 4 The OFR shall complement as well as supplement the financial statements, in order to enhance the overall corporate disclosure.
- 5 The OFR shall be comprehensive and understandable.
- 6 The OFR shall be balanced and neutral, dealing even-handedly with both good and bad aspects.
- 7 The OFR shall be comparable over time.

What are the significant aspects of these principles? The idea of looking through the eyes of the directors is an important feature. It carries the idea of taking shareholders inside the company to reduce the gap between directors, who manage the company, and shareholders, who own the company. The forward-looking orientation is another important feature because shareholders want to make estimates of the future of their investment. 'Forward-looking' does not mean that the company will be making a forecast. The idea of balancing good and bad aspects is important but in practice it may be difficult to persuade directors to say as much about bad aspects as they do about good aspects. One argument the directors put forward is that if they disclose bad aspects of performance there will be loss of confidence and the bad will become worse.

### 14.2.3 Disclosure framework

The ASB does not set out a format or a template. It does not specify headings that must be included in an OFR. However the section of the Reporting Standard describing the disclosure framework runs from paragraphs 27 to 76 with headings and bold-lettered paragraphs and liberal sprinkling of the verb 'shall' (meaning 'must'), so it seems likely that companies will tend to use similar headings.

The framework is introduced by a statement that the OFR shall provide information to assist members to assess the strategies adopted by the entity and the potential for those strategies to succeed. Four key elements of the framework are then specified:<sup>6</sup>

- (a) The nature of the business, including a description of the market, competitive and regulatory environment in which the entity operates, and the entity's objectives and strategies.
- (b) The development and performance of the business, both in the financial year under review and in the future.
- (c) The resources, principal risks and uncertainties and relationships that may affect the entity's long-term value.
- (d) The position of the business including a description of the capital structure, treasury policies and objectives and liquidity of the entity, both in the financial year under review and in the future.

### 14.2.4 Key performance indicators (KPIs)

**Key performance indicators (KPIs)** are quantified measures of factors that help to measure the performance of the business effectively. They reflect 'critical success factors' and show how the entity is progressing towards its objectives.

In a separate section the Reporting Standard RS 1 requires the entity to provide in its OFR sufficient information to enable members to understand each KPI disclosed

in the OFR. These KPIs are expected to become an important help to shareholders in understanding the performance of the entity as seen by the directors.

For each KPI the directors must give a definition and explain the calculation. They must explain the purpose of the KPIs and the sources of data used, together with any assumptions made. There must be a commentary on each KPI and future targets, with comparative figures for the previous year. Where there is a change in a KPI there must be an explanation and a calculation giving comparison to previous years.

Examples of KPIs are:

- Return on capital employed (see Chapter 13).
- Market share – the revenue of the entity as a percentage of the industry total (e.g. a market leader demonstrating dominant position).
- Average revenue per customer (e.g. in a pay-per-view television service)
- Sales per square foot of selling space (e.g. a chain of retail stores).
- Employee costs per £ of sales (any labour-intensive business).
- Environmental spillage (e.g. in a business using toxic chemicals).

### 14.2.5 Particular requirements of the OFR Regulation

Although the government delegated authority to the ASB to provide guidance on the OFR, it also included in the Statutory Instrument specific items of information that must be disclosed.<sup>7</sup> These were listed in RS 1 as information about:

- (a) environmental matters and the impact of the business of the entity on the environment;
- (b) the entity's employees;
- (c) social and community issues;
- (d) persons with whom the entity has contractual or other arrangements which are essential to the business of the entity;
- (e) receipts from, and returns to, members of the entity in respect of shares held by them;
- (f) all other matters the directors consider to be relevant.

For each of the items in (a) to (c) above the OFR was required to include a description of the policies of the entity in each area mentioned and information on the extent to which those policies have been successfully implemented.

This looks a rather piecemeal list compared to the broad sweep of the principles and the disclosure framework, but it reflected the particular concerns of the Company Law Review process in relation to making companies and their shareholders more aware of their social and environmental responsibilities. Environmental groups such as Friends of the Earth were particularly disappointed when the Regulation was withdrawn. Narrative reporting, in less detail, remains a requirement under the EU Modernisation Directive.

### 14.2.6 Directors' and auditors' responsibilities for the OFR

Prior to 2005 the auditors had no direct responsibility in relation to the OFR. They read the narrative part of the annual report and pointed out any inconsistencies between the narrative reports and the financial statements. Directors were not obliged to produce an OFR but if they did so they were expected to show the general duty of care expected of directors. There was no specific legal requirement for their preparation of the OFR.

The Company Law Review proposed that the auditors should be required to review the OFR and recommended that the auditors should review the process by which the OFR is prepared. It was not expected that the auditors would give a direct opinion on the content of the OFR. The government proposed that the auditor should review for: the process by which directors arrive at each statement in the OFR; consistency with the auditors' knowledge from the audit of the accounts, including consistency with the financial statements, and compliance with any applicable standard. During the consultation period there were strong opinions expressed that the additional burden on auditors would be too great. In the final version of the OFR regulation the government reduced the obligation on the auditor to reviewing consistency with knowledge from the audit and consistency with the financial statements. Withdrawal of the Regulation reverted to the position before 2005.

The auditor's opinion is required to establish whether the OFR is consistent with information received during the course of the audit.

### 14.2.7 International developments

The International Accounting Standards Board has asked a project team of national standard setters to develop proposals for a 'management commentary'. The project has been led by the New Zealand Financial Reporting Standards Board and other members of the project team are from standard setters in Canada, Germany and the UK. From the planning drafts it seems likely that there will be similarities with the principles of the UK ASB's RS 1. In the US there is a requirement for a report called the Management's Discussion and Analysis (MD&A). This is required by the Securities and Exchange Commission (SEC) from all companies listed on one of the US stock exchanges (mainly the New York Stock Exchange or the NASDAQ over-the-counter market). The SEC has detailed regulations setting out the content of the MD&A. If you are studying or researching a US listed company you may find the company's MD&A in its annual report or you may find it in the company's report to the SEC (called a 'form 10-K'). The company's web page for 'investors' is often the best place to search. Some UK companies have their shares listed on the New York Stock Exchange or NASDAQ. These companies also prepare an MD&A for the SEC but it is within a report called a 'form 20-F'. You will probably find this on the web page for 'investors' if you are studying or researching a UK company that has a listing in both London and New York.

#### Activity 14.1

*Read through the section on the OFR again. How much of the information suggested for the OFR is extracted directly from the financial statements? How much of the information suggested for the OFR provides additional understanding which is not available from the financial statements?*

### 14.3 Other guidance in analysis

In Exhibit 7.2, there is a list of 'accompanying information' that may be found in the annual report. The first item listed there is the Operating and Financial Review, explained in section 14.2. The second item is the Chairman's statement, which usually appears at the start of the annual report, as a short narrative lasting no more than a page and often preceded by a 'Highlights' statement of key financial measures. The Chairman sets out key features as an introduction to the detail that follows in later

pages. The third item listed there is the Directors' report, which is usually found part-way through the annual report. Its contents are required partly by the Companies Act, partly by the UK Listing Agreement and partly by the Code of Corporate Governance. The fourth item is the historical summaries that allow trends to be seen over several years, with some companies giving five-year trends and others giving ten-year trends. The final item is 'non-accounting and non-financial information'. This covers the rest of the annual report and often provides the most interesting aspects for the reader who wants to understand the company in its entirety.

In this section we will consider the highlights statement and the historical trend analysis.

### 14.3.1 Highlights statement

Safe and Sure plc presents Highlights of Year 7 as follows:

|   |                         | Year 7<br>£m | Increase % | Year 6<br>£m |
|---|-------------------------|--------------|------------|--------------|
| <b>Revenue</b>                          | United Kingdom          | 323.4        | 31.1       | 246.7        |
|   | Europe                  | 164.3        | 7.0        | 153.5        |
|   | North America           | 104.5        | 30.5       | 80.1         |
|   | Asia Pacific and Africa | 122.4        | 12.3       | 109.0        |
|   | Total revenue           | 714.6        | 21.3       | 589.3        |
| <b>Profit</b>                           | United Kingdom          | 97.4         | 28.8       | 69.7         |
|   | Europe                  | 45.3         | 12.4       | 40.3         |
|   | North America           | 17.0         | 22.3       | 13.9         |
|   | Asia Pacific and Africa | 35.5         | 17.9       | 30.1         |
|   | Net interest income     | 2.3          |            | 3.0          |
|   | Profit before tax       | 197.5        | 25.8       | 157.0        |
| <b>Earnings</b>                         | Earnings per share      | 11.74p       | 20.9       | 9.71p        |
| <b>Dividends paid (pence per share)</b> |                         | 3.02p        | 20.8       | 2.50p        |

The Highlights statement shows what the company regards as important information for investors as the primary users of the annual report. Turnover is a measure of the size of operations, with growth of turnover being an indicator of expansion. Profit is the reward for shareholders, with growth again being an important indicator. Segment figures are provided for both turnover and profit. This company has a target profit growth of 20% per annum and so is emphasising that it has more than met the target. Earnings per share and dividend per share are the key indicators from which investors can calculate yields based on the current market price. There is no regulation of highlights statements and so other companies may give different information. Together with the Chairman's statement, the Highlights present the key messages of the annual report.

### 14.3.2 Historical summaries and trend analysis

Listed companies usually provide a historical summary of the financial statements of previous years. The historical summary for Safe and Sure may be found in Appendix I. The analyst may use this table to establish trends of:

- year-on-year growth of turnover and operating profit
- growth rates adjusted for annual inflation
- key ratios.

The company does not usually carry out the ratio analysis; this is left to the analysts to calculate and interpret. On relatively rare occasions the company will provide ratios but it is not always clear which formula has been used.

### 14.3.3 Finance director's review

There are relatively few references to ratios in the annual reports of companies. Some finance directors claim that interpretation of ratios is a very complex matter. They say that if they provide ratio calculations in the annual report, then they will have to provide detailed explanation, which will make the report too lengthy. So in general they leave the ratios for others to calculate and interpret. Sometimes they will comment on a ratio where they know the expert users will ask questions.

In the operating and financial review of Safe and Sure plc the finance director states:

*The pleasing return on our tangible net assets (42.4% per annum before tax on average net assets) reflects the high value of the intangible assets of the Safe and Sure brand and of businesses built up over the years. Such value is not reported in the balance sheet.*

Is it possible to check on the finance director's calculation? He has used pre-tax profit which is £177m (£197.5m from continuing and £20.5m from discontinued operations) and the average of the tangible net assets. The respective figures for Year 7 and Year 6 are £464.3m and £370.4m. The average net assets figure is therefore £417.4m. The calculation of the ratio is:

$$\frac{177}{417.4} \times 100\% = 42.4\%$$

which confirms the figure given by the finance director. (It should be noted that confirming ratios reported in annual reports is not always so straightforward, although it ought to be.) We need other evidence before we can agree that 42.4% is a 'pleasing' return.

In the next section, David aims to explain his approach to using ratios to pinpoint target areas for probing by way of questions to the company, while Leona explains how ratios are useful to the auditor.

### 14.3.4 The analyst and the auditor



**DAVID:** *We subscribe to the major on-line database sources of information about companies, so I don't very often sit down to calculate ratios. I'm more interested in the interpretation. There are a few key ratios that I look at for major clues as to strange goings-on and then I scan a more detailed ratio report for unusual changes. We can program in an instruction to set a warning flag against any ratio which has altered by more than a specified range since the previous figures, or over a given period of time.*

*What do I look to first? Gross margins on turnover and net margins on turnover, with as much segmental detail as I can find. Segmental information is an area where often we do have to carry out our own analysis using our skills, experience and specialist sources of information. Not many databases break down the company's results by segment. Then I'll check the tax charge as a percentage of the taxable profit. It should be around 30% if the company's accounts have been accepted for tax purposes, but if there are items which the tax authorities don't allow, then the percentage will be different. I'm always interested in what appears in the profit and loss account but is not accepted by the tax rules. Depreciation is a notoriously variable figure and is difficult to spot because the accounting rules say that a change in depreciation rate or useful asset life is not a change in policy. Companies have to draw attention to a change in policy and explain the impact. Depreciation escapes that rule. So I calculate the depreciation charge as a percentage of total asset value. If that percentage changes then I start asking questions.*

*Common-size statements are very useful. That means turning all items in the financial statements to percentages with the total assets represented by 100% in the balance sheet and the turnover represented by 100% in the profit and loss account. It is also useful to*

have percentage changes from one year to the next. That is all relatively easy when you are using spreadsheets.

Over a period of time I monitor the variability of a ratio for a particular company. I calculate this as:

$$\frac{\text{Maximum value} - \text{Minimum value}}{\text{Mean value of ratio}}$$

Again I am looking for unusual movements outside an expected range.

LEONA: The auditors don't rely on anyone else's calculations. We carry out our own ratio analysis as part of our analytical review. For commercial, manufacturing and service companies we monitor a standard list of ratios which is:

- acid test ratio
- current ratio
- customers collection period
- inventories (stocks) holding period
- gearing
- interest cover
- return on capital employed
- return on total assets
- gross profit margin.

We are looking at these with a focus on the particular concerns of the auditor. Possible liquidity crises or working capital shortages could raise a question as to whether the company is a going concern. Customer collection period provides a clue to whether the doubtful debt provision is adequate. Inventories holding period may indicate a need for provision for slow-moving inventories. Gearing and interest cover are further indicators of financial stability or otherwise in relation to the going concern issue. Return on capital employed and on total assets may show inefficient use of assets and perhaps point to assets which have no future benefit. Gross margins may cause us to ask questions about incorrect records of sales or stocks if the margins are different from the norms.

For listed companies we also look at the dividend cover and the Altman Z-score. The Z-score is a model developed for use in predicting insolvency. You need to read a finance textbook to get the details, but basically it is a combined score based on a list of key variables all pointing to potential insolvency problems. We have to be able to say that the business is a going concern, so that kind of information is important to us.

DAVID: That's OK for the current year. What about trends?

LEONA: Yes, trends are an important part of our review. We try to use a predictive approach and estimate the current year's figure from the previous data rather than merely compare this year with last. Taking a predictive approach encourages us to challenge fluctuations and to seek persuasive explanations. We use all the familiar forms of trend analysis – graphical representation, moving averages and simple regression analysis.

DAVID: How much reliance do you place on these analytical procedures?

LEONA: It can range from conclusive reliance to no reliance at all. It depends very much on the nature of the assertions being tested, the plausibility and predictability of the relationships involved, and the extent to which data is available and reliable.

DAVID: Maybe I have underestimated auditors in the past. None of the activities you describe is really apparent from the audit report. Perhaps you undersell your work.

LEONA: I probably have to admit that our work stops when we have gained sufficient assurance to write the audit report. We don't give information to the reader – that is not the function of the audit.

DAVID: *You and I need to spend more time together on this question of analysis in depth. Analysts with insight command top ratings and that's what I'm looking for. And I think the benefit would not all be one-way – I can help you with broader awareness of the strategies used by management in giving the markets the messages they want to convey.*

LEONA: *Sounds fine to me.*

## 14.4 Segmental information

In Sections 7.7 and 7.8, you have read about the group structure used by many companies, and you have seen the method of construction of consolidated financial statements. Safe and Sure presents consolidated financial statements, which are discussed in section 7.4. The process of consolidation of financial information in group accounts is intended to be an improvement on sending the parent company shareholders a bundle of the separate financial statements of each member of the group. It lets them see, in one set of financial statements, the full picture of the group. On the negative side, the process of aggregation causes a loss of information about the various different activities of the group. In order to balance the benefits of aggregation with the need for detail, accounting provides additional information about the various segments of the group on a year-by-year basis.

### 14.4.1 Users' needs for information

Consolidated financial statements are a very convenient means of bringing together a large volume of data, but they suffer a major defect in losing much of the rich detail available from seeing each constituent company separately. It is particularly important for users of financial statements to know how the results of various activities compare, where the group of companies is involved in more than one product line and more than one type of market.

Segmental reporting has developed as a means of supplementing the consolidated financial statements by providing more insight into the activities of the group. In particular it reports information about the different types of products and services that an entity produces and the different geographical areas in which it operates. Segmental information helps users of financial statements in three ways. It helps the user to a better understanding of the entity's past performance, a better assessment of the entity's risks and returns and a more informed judgement about the entity as a whole.<sup>8</sup>

The accounting standard which deals with segmental reporting requires the group to identify primary segments and secondary segments. The managers start by identifying the dominant source and nature of an entity's risks and returns. If the risks and returns are dominated by the products and services of the business then the primary segments are defined by products and services. The secondary segments are the geographical locations of sales or output. If the risks and returns are dominated by operations carried out in different locations then the geographical segments are the primary segments and the products or services are the secondary segments.<sup>9</sup>

For each primary segment the following list contains the main items that the entity must report:

- segment revenue, separating sales to external customers from transactions within the group;
- segment results (profits or losses) separating the results of continuing and discontinued operations;
- total carrying amount of segment assets for each reportable segment;
- segment liabilities for each reportable segment;

- total cost of acquiring non-current (fixed) assets in the period;
- total depreciation or amortisation of non-current assets;
- total of other non-cash expenses;
- segment cash flow based on IAS 7.

For the secondary segment less information is required because it is partly covered through overlap of primary and secondary segments. If the primary format is based on business segments and the secondary segments are based on geographical spread, then the entity must report for the secondary segments:

- segment revenue from external customers;
- the total carrying amount of segment assets by geographical location; and
- total cost incurred to acquire segments assets.

If the primary format is based on geographical location of output or sales and the secondary segments are based on geographical spread, then the entity must report for the secondary segments:

- the total carrying amount of segment assets by geographical location; and
- total cost incurred to acquire segments assets.

#### 14.4.2 Information provided in the financial statements

The group balance sheet and profit and loss account of Safe and Sure plc are presented in full in Chapter 7 and have been explored in more detail in subsequent chapters. Consequently you are already familiar with much of the information about the assets and liabilities of the group.

##### *Parent company*

Some companies publish the balance sheet of the parent company alongside or near to the group balance sheet. This is a requirement for groups that continue to report under UK rules, but is not compulsory for group accounts prepared under the IASB system. In most cases the parent company balance sheet confirms that the parent is primarily a holding company whose main asset is the investment in its subsidiaries. It owns some of the group's land and buildings and a small portion of the vehicle fleet. Its current assets consist mainly of amounts owed by subsidiaries and dividends due from subsidiaries. Its current liabilities consist mainly of amounts owed to subsidiaries and dividends payable to its own shareholders. The parent company has some long-term liabilities for money borrowed to purchase subsidiaries. Most of the cash used for purchase of new subsidiaries is provided by the new wealth generated by the group as a whole.

##### *Group*

Information about the Safe and Sure group is very much more interesting than information about the parent company alone. That is why the preceding chapters have used the group information about Safe and Sure to explain the treatment of assets, liabilities and ownership interest. There are a few particular items of interest in respect of acquisitions of new subsidiaries and the use of the goodwill reserve. There is also some interesting information about the various segments of the business which contribute to the overall picture. This section summarises those particular features of the annual report.

#### 14.4.3 Identifying segments

The IASB system requires the business and geographical segments reported by an entity to be the organisational units for which information is reported to the board of

directors. The board of directors use the information for evaluating past performance and making decisions about future allocation of resources. So the intention is that the segment reporting reflects the information that management is using in running the business. In identifying distinguishable business segments the management should consider the nature of the products or services and the way these are produced or provided, the types of customer, the methods of distribution and any regulations that apply to the product or service. In identifying geographical segments, management should consider economic and political conditions, relationships of operations across geographical areas, special operational risks, underlying currency risks and any restrictions on exchanging currencies.

#### 14.4.4 Segmental information in Safe and Sure

As an illustration of the type of segmental information available, the note to the profit and loss account of Safe and Sure plc is set out in Note 16 to the financial statements. It is one of the lengthiest notes provided by the company.

##### Note 16 Segmental analysis

###### Primary reporting format – business segments

For management purposes the group is currently organised into two operating divisions, (1) disposal and recycling, (2) security and cleaning. Disposal and recycling includes all aspects of collection and safe disposal of industrial and commercial waste products. Security and cleaning is undertaken by renewable annual contract, predominantly for hospitals, other healthcare premises and local government organisations.

The group's disposal and recycling operation in North America was discontinued with effect from 30 April Year 7.

###### Business sector analysis

|                                    | <i>Disposal and recycling</i> |              | <i>Security and cleaning</i> |              | <i>Total</i>  |               |
|------------------------------------|-------------------------------|--------------|------------------------------|--------------|---------------|---------------|
|                                    | Year 7                        | Year 6       | Year 7                       | Year 6       | Year 7        | Year 6        |
|                                    | £m                            | £m           | £m                           | £m           | £m            | £m            |
| REVENUE                            |                               |              |                              |              |               |               |
| Continuing                         | 508.9                         | 455.0        | 205.7                        | 134.3        | 714.6         | 589.3         |
| Discontinued                       | <u>20.0</u>                   | <u>11.0</u>  |                              |              | <u>20.0</u>   | <u>11.0</u>   |
| Total revenue                      | <u>528.9</u>                  | <u>466.0</u> | <u>205.7</u>                 | <u>134.3</u> | <u>734.6</u>  | <u>600.3</u>  |
| Operating profit (loss) by service |                               |              |                              |              |               |               |
| Continuing                         | 176.6                         | 139.6        | 18.6                         | 14.4         | 195.2         | 154.0         |
| Discontinued                       | (20.5)                        | (10.0)       |                              |              | (20.5)        | (10.0)        |
| Total operating profit             |                               |              |                              |              | 174.7         | 144.0         |
| Interest receivable (net)          |                               |              |                              |              | <u>2.3</u>    | <u>3.0</u>    |
| Profit before tax                  |                               |              |                              |              | 177.0         | 147.0         |
| Taxation                           |                               |              |                              |              | <u>(62.2)</u> | <u>(52.4)</u> |
| Profit for the period              |                               |              |                              |              | <u>114.8</u>  | <u>94.6</u>   |

All costs of head office operations are allocated to divisions on an activity costing basis.

Other segment items included in the income statement are as follows:

|                        | <i>Disposal and recycling</i> |        | <i>Security and cleaning</i> |        | <i>Total</i> |        |
|------------------------|-------------------------------|--------|------------------------------|--------|--------------|--------|
|                        | Year 7                        | Year 6 | Year 7                       | Year 6 | Year 7       | Year 6 |
|                        | £m                            | £m     | £m                           | £m     | £m           | £m     |
| Depreciation           | 30.2                          | 25.1   | 3.0                          | 3.9    | 33.2         | 29.0   |
| Impairment of goodwill | 1.6                           | –      | –                            | –      | 1.6          | –      |

The segment assets and liabilities at the end of Years 7 and 6, with capital expenditure for each year are as follows:

|                     | <i>Disposal and recycling</i> |        | <i>Security and cleaning</i> |        | <i>Unallocated</i> |        | <i>Total</i> |        |
|---------------------|-------------------------------|--------|------------------------------|--------|--------------------|--------|--------------|--------|
|                     | Year 7                        | Year 6 | Year 7                       | Year 6 | Year 7             | Year 6 | Year 7       | Year 6 |
|                     | £m                            | £m     | £m                           | £m     | £m                 | £m     | £m           | £m     |
| Total assets        | 498.5                         | 370.9  | 68.7                         | 132.7  | 120.1              | 112.3  | 687.3        | 615.9  |
| Total liabilities   | 131.7                         | 147.9  | 61.3                         | 85.5   | 30.0               | 12.1   | 223.0        | 245.5  |
| Capital expenditure | 50.0                          | 45.0   | 10.2                         | 2.5    | –                  | –      | 60.2         | 47.5   |

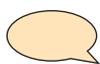
### Secondary reporting format – geographical segments

The group's two business segments operate in four main geographical areas, even though they are managed on a worldwide basis. In the following analysis, revenue is based on the country in which the order is received. It would not be materially different if based on the country in which the customer is located. Total assets and capital expenditure are allocated based on where the assets are located.

|                       | <i>Sales</i> |              | <i>Total assets</i> |              | <i>Capital expenditure</i> |             |
|-----------------------|--------------|--------------|---------------------|--------------|----------------------------|-------------|
|                       | Year 7       | Year 6       | Year 7              | Year 6       | Year 7                     | Year 6      |
|                       | £m           | £m           | £m                  | £m           | £m                         | £m          |
| CONTINUING            |              |              |                     |              |                            |             |
| United Kingdom        | 323.4        | 246.7        | 294.6               | 250.1        | 40.2                       | 25.1        |
| Continental Europe    | 164.3        | 153.5        | 152.7               | 156.4        | 1.5                        | 2.3         |
| North America         | 104.5        | 80.1         | 145.2               | 82.8         | 10.6                       | 15.4        |
| Asia Pacific & Africa | <u>122.4</u> | <u>109.0</u> | <u>94.8</u>         | <u>126.1</u> | <u>7.9</u>                 | <u>4.7</u>  |
|                       | 714.6        | 589.3        | 687.3               | 615.4        | 60.2                       | 47.5        |
| DISCONTINUED          |              |              |                     |              |                            |             |
| North America         | <u>20.0</u>  | <u>11.0</u>  | <u>–</u>            | <u>0.5</u>   | <u>–</u>                   | <u>–</u>    |
| Total                 | <u>734.6</u> | <u>600.3</u> | <u>687.3</u>        | <u>615.9</u> | <u>60.2</u>                | <u>47.5</u> |

The information contained in Note 16 relates to a service business, so it might be expected that the net assets would be relatively low compared to the turnover and operating profit. Professional analysts would be particularly interested in the relationships and trends underlying these figures.

David and Leona have returned from their holiday and are again working on Leona's flat. In the middle of a less than successful attempt to fit a carpet, David pauses for coffee and explains how he looked at the segmental information presented by the company.



**DAVID:** *The first thing I did here was to feed all these tables of segmental information into our spreadsheet package. I asked for two printouts initially. The first calculated the sales (revenue) as a multiple of net assets and the operating profit as a percentage of sales, using continuing activities in each case because the assets remaining at the end of the period do not include the assets of the discontinued activity. [The results are shown in Exhibit 14.1, panel (a).] The second printout shows the sales to total assets for each geographical area. [The results are shown in Exhibit 14.1, panel (b).] From this the relative strengths and weaknesses within the organisation begin to emerge. The percentage changes (Exhibit 14.2) also show some interesting differences. I need to ask why the total assets for security and cleaning have reduced so much when there was no disposal in this segment. Perhaps the assets were transferred into disposal and recycling to replace those that were discontinued.*

**Exhibit 14.1****Analysis**

(a) Analysis of business segment sales and operating profit (based on continuing activities)

| Segment                | Sales as a multiple of total assets |        | Operating profit as a % of sales |          |
|------------------------|-------------------------------------|--------|----------------------------------|----------|
|                        | Year 7                              | Year 6 | Year 7 %                         | Year 6 % |
| Disposal and recycling | 1.02                                | 1.23   | 34.7                             | 30.7     |
| Security and cleaning  | 2.99                                | 1.01   | 9.0                              | 10.7     |

(b) Analysis of geographical segment sales compared to total assets

| Geographical analysis   | Sales as a multiple of total assets |        |
|-------------------------|-------------------------------------|--------|
|                         | Year 7                              | Year 6 |
| United Kingdom          | 1.10                                | 0.99   |
| Continental Europe      | 1.08                                | 0.98   |
| North America           | 0.72                                | 0.97   |
| Asia Pacific and Africa | 1.29                                | 0.86   |

**Exhibit 14.2****Percentage changes on previous year**

|                  | Disposal and recycling | Security and cleaning | Total       |
|------------------|------------------------|-----------------------|-------------|
|                  | Year 7                 | Year 7                | Year 7      |
|                  | % on Year 6            | % on Year 6           | % on Year 6 |
| Sales (revenue)  | +11.8                  | +53.0                 | +21.3       |
| Operating profit | +26.5                  | +29.2                 | +25.0       |
| Total assets     | +34.4                  | negative              | +11.6       |

*Then I turned to the front of the annual report. The importance of segmental information becomes apparent as soon as you start to read the chairman's statement and it continues through the business reviews, presented on a segmental basis with some helpful illustrations to reinforce the message. The chief executive's review continues the segmental theme strongly and gives further information to augment the basic tables which I have already analysed. That attention to detail in their reports is a reflection of the thorough questioning which these people receive from the fund managers and analysts who follow the company closely. I know one analyst who would put Sherlock Holmes in the shade. She collects the accounts of each individual UK company in the group, and as many overseas subsidiary companies as she can get hold of. She puts them all together like a jigsaw and then starts to ask intensive questions based on what she has and what she can deduce about the missing pieces. Seasoned finance directors wilt visibly under her interrogation!*

**LEONA:** *Segmental reporting is an area where you and your analyst friends probably put more pressures on the companies than we can as auditors. That's a good example of market forces at work, but it does assume that the information you prise out of the company is made available more widely. Companies make use of the operating and financial review to answer the questions which they know the investors ask on a regular basis.*

## 14.5 Off-balance-sheet finance

One major problem for UK accounting emerged in the 1980s in a period of business expansion. To finance expansion, companies were borrowing and therefore increasing their gearing ratios. Some companies looked for ways of avoiding disclosing in the balance sheet the full extent of the commitment on borrowed funds. Omitting the item from the balance sheet could not remove the commercial obligation but it could reduce the questions arising from those who would read the financial statements.

The accounting question is: How do you remove, or fail to include, a liability so that no one will notice? The answer, as with all accounting questions, starts in the accounting equation. To keep the equation in balance, any removal of a liability must be matched by removal of an asset of equal amount.

Many ingenious schemes emerged, but one of the least complex is the sale and leaseback of land and buildings.

### 14.5.1 Sale and leaseback of property

Consider the following scenario. A company has the following balance sheet:

|   |           |
|---|-----------|
|   | £m        |
| Land and buildings                            | 20        |
| Other assets, <i>less</i> current liabilities | <u>15</u> |
|   | 35        |
| Less long-term loan                           | (20)      |
| Net assets                                    | <u>15</u> |
| Share capital                                 | <u>15</u> |

The company sells the land and buildings for £20m and repays the loan. The balance sheet now appears to contain no gearing:

|   |           |
|---|-----------|
|   | £m        |
| Other assets, <i>less</i> current liabilities | <u>15</u> |
| Share capital                                 | <u>15</u> |

However, enquiry behind the scenes reveals a complex arrangement. The land and buildings were sold to a consortium of finance companies, but on the same day a lease was signed that allowed the company to continue occupying the property at a rental payment which would vary according to current rates of interest and would be calculated as a percentage of the £20m cash received. In five years' time the company would have the option to repurchase the land and buildings at £20m and the consortium of finance companies would have the option to force the company to repurchase at £20m. These options would mean that if the price rose over the next five years the company would wish to buy at £20m. If the price fell over the next five years the consortium would insist on repurchase.

Now ask yourself, where do the benefits and risks of this contract lie? The benefits of a rise in value and the risks of a decrease in value remain with the company, as they would if the company had remained the owner. The company will pay a rental which looks very much like an interest payment on a loan of £20m. If the company fails to meet its obligations, then the consortium will claim the asset. The commercial effect of this transaction is that of a loan based on the security of the asset of land and buildings.

### 14.5.2 UK response

In the absence of a standard to back up the argument, auditors felt unable to argue against the directors of companies who moved assets and liabilities off the balance

sheet. After some years of consultation and discussion with interested parties, the UK ASB decided that such transactions did not change the commercial substance of the transaction and it is the commercial substance which matters. A standard was introduced to require a transaction of this type to be reported on the balance sheet<sup>10</sup> in the form of an asset and matching liability. Not all countries shared this view because it involved making a judgement on the balance of risks and rewards. Making judgements leaves the company and the auditors open to challenge and so it could be argued that specific rules are preferable to general principles. In particular the US had a more rules-based approach to defining recognition on and off the balance sheet.

### 14.5.3 Special purpose entities

The problems associated with off-balance-sheet finance received high public profile at the end of 2001, running into 2002, with the failure of a large US company called Enron. Because of the size of the company and the political impact of its failure, hearings were called by the US Congress at which witnesses gave evidence on accounting practices, among other matters. One of the accounting issues discussed was the question of 'off-balance-sheet finance'. The Chief Accountant of the Securities and Exchange Commission described to the House of Representatives how money could be borrowed at advantageous rates of interest using a 'special purpose entity' which was not consolidated with the rest of the group accounts. Provided the assets of the special purpose entity retained sufficient value, the lender would be content with the arrangement. If the assets fell in value then the lender would look to the parent company for reimbursement. Shareholders in the parent would be unaware of the extent of such borrowing until the lenders demanded repayment. At the time of the failure of Enron the US standard-setting body (the Financial Accounting Standards Board) was still in the process of providing guidance on consolidation of such special purpose entities. The International Accounting Standards Board had no standard that directly addressed such entities.

Subsequently the US regulators and the IASB strengthened their rules relating to special purpose entities, to bring these entities into group financial statements.

#### Activity 14.2

*Off-balance-sheet finance is one example of information which would never come to the attention of the users of financial statements but for the concern of some auditors. Make a list of other types of information which may be evident to the auditors but which are unlikely to be conveyed to the readers. Consider this list in the light of the requirement that financial statements must show a true and fair view. To what extent is the reader of financial statements reliant on the directors and the auditors?*

## 14.6 Corporate social responsibility

Corporate social responsibility means that entities report to stakeholders on the ways in which social and environmental concerns are integrated with their business operations.

#### Definition

**Corporate social responsibility** means that companies integrate social and environmental concerns in their business operations and in their interactions with stakeholders.

Companies disclose in their annual reports more information than is represented only in financial statements. Depending on social attitudes or pressures, companies may voluntarily disclose additional information intended to confirm the company's sense of social responsibility. In some instances, the provisions of law eventually catch up with the values of society and disclosures become mandatory. Section 14.2.5, explains that in the UK the OFR Regulation requires the OFR to include information about environmental matters and social and community issues.

Investors are increasingly asking questions about the corporate social responsibility of the companies in which they invest. Many investors want to be reassured that the businesses in which they have a stake adopt ethical business practices towards employees, the community and the environment. You will see increasing numbers of what are described as 'ethical investment funds' which make careful enquiry before buying shares. Some ethical investors feel that they are best placed to influence a company if they become shareholders; others feel that they should not become shareholders until the company has a sound policy.

### 14.6.1 Types of disclosure

Examples of social disclosure on mandatory topics include: information about pensions for employees, employees' share option schemes, policy regarding employment of disabled persons, donations to charity and consultation with employees. Social disclosure on a voluntary basis includes: information about employee matters, health and safety, community work, energy and the environment.

In terms of relative volume, the amount of information disclosed about employee-related matters exceeds other types of social and environmental disclosures, but the area where there is the fastest growth in interest is that of environmental issues. Many leading companies now have an 'environment' section in the annual report and some go even further in producing a separate environmental report.

Below are extracts from the 'environment' section of the report of the directors of Safe and Sure plc, the company used for illustration throughout this text.

*Safe and Sure is committed to the provision of services and products which improve the quality of life, both for our customers and the community, using working practices designed to protect the environment.*

*Heightened awareness of environmental issues and increased legislation provide a focal point for developing greener techniques and solutions to problems, both in our more traditional businesses and also in offering opportunities to develop new businesses.*

*Antibacterial deep cleaning of premises, in particular high-risk areas such as washrooms, drains and food production and preparation areas, has been developed to meet increased legislation and concern as to health and food safety.*

*It is the responsibility of the company and all its employees to ensure that all services and products are procured, produced, packaged and delivered, and waste materials ultimately disposed of, in ways which are appropriate from an environmental viewpoint. It is the responsibility of our employees to carry out their work in a manner that will not cause damage to the environment.*

### 14.6.2 Need for measurement

Social and environmental disclosures in annual reports have so far centred on narrative description in the directors' report or in the non-statutory part of the document. There is little evidence of impact on the accounting numbers but that may be the next step. Environmental obligations create liabilities. An oil rig in the North Sea will eventually have to be removed. The liability may be regarded as existing now because the event

creating the obligation was the original act of positioning the rig in the oil field. But what will eventual removal cost? Will the rig be dismantled to a few hundred feet below the surface, out of the way of fishing nets? Will it be dismantled down to the sea bed with the debris left behind? Will the rig be towed away for dismantling elsewhere? Until these questions can be answered, the liability cannot be measured as a money amount and therefore cannot be recognised in the balance sheet. Most oil companies make a provision each year towards the ultimate cost of removal of the rig and they accumulate the provision in the balance sheet. They do not, in general, report the full liability at the outset.

### 14.6.3 The Global Reporting Initiative

The Global Reporting Initiative (GRI) is a venture that was started through a link between the United Nations Environmental Programme and a US body called the Coalition for Environmentally Responsible Economies. It has developed into a global institution that sets out a disclosure framework, called the GRI Guidelines, for sustainability reporting. Companies are increasingly referring to the GRI Guidelines in designing parts of their annual report. The recommendations include reporting on vision and strategy, the profile of the organisation, the governance structure and management system, and performance indicators. These indicators should cover economic, environmental and social performance. This combination is sometimes referred to in the press as 'the triple bottom line'. The reason for this description is that for many years the earnings for equity holders has been described as 'the bottom line' (of the income statement). So extending to three performance measures leads to a triple bottom line.

### 14.6.4 The Kyoto Protocol

International agreements on supporting sustainable development have consequences for accounting. One example is seen in the Kyoto Protocol, an agreement resulting from a conference held in Kyoto, Japan in 1997 as an amendment to the United Nations Framework Convention on Climate Change. The Kyoto Protocol set out measures for dealing with problems of climate change by reducing greenhouse gas emissions. Some countries were more reluctant than others to ratify the agreement (confirm that they will make it operational) although gradually more companies have agreed. All Member States of the EU have ratified the Protocol but by 2005 the US government was still not committed. The agreement requires action to be taken to reduce carbon-based emissions (particularly carbon dioxide) over a defined time-scale. Countries are given limits of emissions of greenhouse gases. The countries then set limits on companies in specified industries.

One interesting feature of the Kyoto agreement is that companies are given 'allowances to emit'. The allowance, in the form of a licence, is capable of being transferred from one company to another. The entity that buys a licence to emit acquire an asset. This in turn creates new assets and liabilities for individual companies. The liabilities are easier to see: companies which do not reduce emissions will face penalties. However there are also be opportunities to take actions that prevent emissions and extract value from the new carbon market. If these actions meet the definition and recognition criteria, they are regarded as assets. The European Union Greenhouse Gas Emissions Trading Scheme began in January 2005. It establishes a market in carbon dioxide gas emissions for companies in specified industry sectors. Information on emissions trading is seen in annual reports published from 2005 onwards.

There is no international accounting standard dealing directly with accounting for the environment and sustainable development but there are interested groups working on the accounting issues in various countries.

**Activity 14.3**

*Write down the accounting equation: Assets minus Liabilities equals Ownership interest. Suppose you are the accountant for an oil company and you have been asked to record the full liability for dismantling an oil rig in 20 years' time. How would you make the accounting equation balance?*

## 14.7 Corporate governance

The term **corporate governance** is used to describe the way in which companies are directed and controlled. In Chapter 1 the idea of stewards and their agents was put forward briefly as a model of the relationship between shareholders and the directors of a company. It could be argued that these two groups could be left together to work out their fate, but a series of well-publicised corporate failures and financial scandals of the 1980s raised concern that such a system does not always work and the public interest may suffer as a result.

There has therefore been considerable interest in intervening to improve the quality of corporate governance. The issue has been high on the agenda in several of the English-speaking countries and the ideas have strong international interest although perhaps translated into different words and phrases.

### 14.7.1 The Combined Code

In the UK, the government has taken some action through legislation but has largely followed the traditional route of encouraging the self-regulatory approach. One of the most important aspects of this self-regulatory approach was the 1992 report of what is usually referred to as the Cadbury Committee.<sup>11</sup>

The Cadbury Committee was set up by the Financial Reporting Council, the London Stock Exchange and the accountancy profession. It was asked to report on a range of issues concerned with the way directors run their companies and auditors monitor those companies, considering also the links between directors, auditors and shareholders. The recommendations of the Cadbury Committee were wide-ranging but included proposed improvements in financial reporting such as:

- more detail in the interim reports
- clearer information about directors' remuneration
- effective use of the operating and financial review
- the effectiveness of the internal control procedures used by the business
- reassurance that the business is a going concern
- a statement of the responsibilities of directors.

Although the report was issued in 1992 it took some time for further working parties to agree on the manner of reporting on internal controls and the going concern confirmation. By the end of 1995 these were in place and 1996 saw the start of a review of the first three years of implementing the Cadbury Report.

The review was chaired by Sir Ronald Hampel, so that the report which eventually appeared in 1998 was called 'The Hampel Report'.<sup>12</sup> It took as its starting point the view that good corporate governance was not merely a matter of complying with a number of hard and fast rules. There was seen to be a need for broad principles. It was important to take account of the diversity of circumstances and experience among companies, and within the same company over time. On this basis Hampel suggested that the true safeguard for good corporate governance lay in the application of informed and independent judgement by experienced and qualified individuals – executive and non-executive directors, shareholders and auditors. Relatively little

was said about financial reporting, beyond the assertion that the board of directors should present a balanced and understandable assessment of the company's position and prospects.<sup>13</sup>

Following the Hampel Report, the Stock Exchange issued a Combined Code for listed companies containing recommendations on directors; directors' remuneration; relations with shareholders; and accountability and audit. The accountability section emphasised the responsibilities of directors in respect of financial reporting. They should present a balanced and understandable assessment of the company's position and prospects. In particular they should explain their responsibilities and they should also report that the business is a going concern.

The Combined Code was subsequently taken into the responsibility of the Financial Reporting Council. The FRC revised the Code in 2003 and reviewed it in 2005. The work is carried out by the FRC's Committee on Corporate Governance.

### 14.7.2 Directors' remuneration

There is a continuing interest in the subject of directors' remuneration, partly because it provides opportunities for newspaper headlines. Typically the interest of financial journalists focuses on the salary of the highest paid director and the amount that person is gaining through share option schemes. These schemes allow directors to obtain each year the option to buy shares at an agreed price. If the share price rises subsequently the directors exercise the option, buy the share at the agreed price and may sell immediately at a profit. Some companies offer such options to some or all of their employees by way of encouraging loyalty to the company and supplementing cash salaries.

In response to well-publicised concerns about the need to disclose and control the level of directors' remuneration, a study group chaired by Sir Richard Greenbury (1995) produced a code of best practice on disclosure and remuneration policy.<sup>14</sup> These recommendations were subsequently taken into legislation on disclosure of directors' remuneration and into the Combined Code on Corporate Governance. A typical annual report of a listed company contains several pages on the remuneration policy and the payments to directors.

#### Activity 14.4

*Obtain the annual report of a listed company. Turn to the report on corporate governance. What does the company say about corporate governance and about compliance with the Combined Code? What do the auditors say about the report on corporate governance? What is disclosed about the remuneration committee? What information is given elsewhere in the annual report, relating to directors' remuneration?*

## 14.8 Developing issues: 'Present fairly' and 'true and fair view'

The IASB system of accounting requires financial statements to *present fairly* the financial position, financial performance and cash flows of an entity.<sup>15</sup> In virtually all circumstances a fair presentation is achieved by compliance with the applicable IFRSs.<sup>16</sup> Entities cannot use notes or explanatory material to compensate for inappropriate accounting policies – the choice of policies must in itself achieve a fair presentation.<sup>17</sup> In the extremely rare circumstances where management considers that compliance with a requirement of an IFRS would conflict with the objective of a fair presentation, the entity will depart from the requirement and explain the reasons and consequences.<sup>18</sup>

The Companies Act 1985 requires that financial statements of companies should show a *true and fair view*.<sup>19</sup> In most situations a company will achieve a true and fair view by following the requirements of company law and UK accounting standards. In the rare circumstances where management considers that compliance with a requirement of law and standards would conflict with the true and fair view, the entity will depart from that requirement and explain the reasons and consequences.

### 14.8.1 Equivalence of meaning

The question arises as to whether ‘present fairly’ and ‘a true and fair view’ have different meanings. The Financial Reporting Council (FRC)<sup>20</sup> has pointed out that UK companies which follow the IASB system are only permitted to use IFRSs that have been approved by the European Commission. The condition for approval is that the IFRS must be consistent with the basic requirement to give a true and fair view which applies across the European Union. The FRC has also pointed out that the IASB Framework equates ‘true and fair view’ and ‘fair presentation’ in asserting that the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view or a fair presentation of information.<sup>21</sup>

The remainder of this section discusses the meaning of ‘true and fair view’ because it has a longer history of debate and development in the UK. The phrase ‘true and fair’ was taken into European Directives when the UK joined as a Member State but it has never found an exact equivalent in the underlying meaning. For example the French wording ‘image fidèle’ is closer to ‘a faithful picture’.

The UK has traditionally taken the position that it may be necessary for individual companies to take action which contravenes legal rules, in the interest of presenting ‘a true and fair view’. In other countries, including the US, the position taken is generally that the law prevails and any questions about fair presentation should be analysed within the legal framework. The US wording is ‘faithful representation’.

### 14.8.2 Meaning of a true and fair view

The UK Companies Act provides no definition of the meaning of ‘a true and fair view’. Consequently from time to time those who set accounting standards have sought the opinion of expert legal advisers. The lawyers have put forward the view that the requirement for a true and fair view is a dynamic concept which changes its nature as the general values of society change. Although the words stay the same, the meaning of the words changes because the opinions of society in general change.

What does that mean in practice? The lawyers have provided an example.<sup>22</sup> The Bill of Rights 1688 prohibited ‘cruel and unusual punishments’. The dictionary definition of ‘cruel’ has changed little since that time but a judge today would characterise as ‘cruel’ some punishments which a judge of 1688 would not have regarded as cruel. The meaning of the word remains the same but the facts to which it is applied have changed. Based on reasoning of that type, the lawyers have argued that the words ‘true and fair’ may carry the same dictionary meaning from one time to another but the accounting principles and practice contributing to a true and fair view will change as circumstances change.

One very important issue is the question of whether society, and the public interest, would expect the application of accounting standards to be necessary as evidence of intent to apply a true and fair view. Legal advice provided to the ASB analysed the role of an accounting standard:

*What is the purpose of an accounting standard? The initial purpose is to identify proper accounting practice for the benefit of preparers and auditors of accounts. However, because*

*accounts commonly comply with accounting standards, the effect of the issue of standards has also been to create a common understanding between users and preparers of accounts as to how particular items should be treated in accounts and accordingly an expectation that, save where good reason exists, accounts will comply with applicable accounting standards.<sup>23</sup>*

Accounting standards have, over a period of years, become regarded as an authoritative source of accounting practice. The legal opinion given to the ASB is that accounting standards provide very strong evidence of the proper practice which should be adopted. The ‘true and fair view’ is seen as a dynamic concept:

*Thus what is required to show a true and fair view is subject to continuous rebirth and in determining whether the true and fair requirement is satisfied the Court will not in my view seek to find synonyms for the words ‘true and fair’ but will seek to apply the concepts which those words imply.<sup>24</sup>*

### 14.8.3 Who is responsible for the true and fair view?

Under company law, it is the directors who are responsible for ensuring that the accounts are prepared in such a way as to show a true and fair view. The auditors state whether, in their opinion, the accounts show a true and fair view. If you turn back to Chapter 4 you will see an example of the statement of directors’ responsibilities which now appears in many company reports and also a copy of the auditors’ report. Both contain the phrase ‘a true and fair view’ and emphasise the different types of responsibility held by directors and auditors.

### 14.8.4 How specific is the ‘true and fair’ concept?

You should have gained an understanding, from various chapters of this book, that there is more than one accounting treatment for many transactions and events. It is a great puzzle to many people that companies could produce different accounting statements for one particular period of time, each of which would show a true and fair view. The answer lies in one very small word. The requirement of law is for ‘a true and fair view’ but not for ‘the true and fair view’. Thus the directors do not have to find ‘the very best true and fair view’, which may surprise some users of financial statements. It also becomes very difficult for auditors to enter into dispute with directors where there are two acceptable alternatives, either of which could result in a true and fair view. To be successful in contradicting the directors, the auditors need to show that a particular practice does *not* show a true and fair view. If they can successfully argue that opinion then the company has the choice of revising the proposed treatment or facing a *qualified* audit opinion. Here is an example of a qualified audit opinion where the auditor and directors were in disagreement:

#### Qualified audit opinion

*We found that the company has made no provision for doubtful debts, despite circumstances which indicate that such a provision is necessary.*

*In our opinion the accounts do not give a true and fair view . . .*

It is therefore essential, in reading the annual report, to read the auditors’ report at an early stage in order to be aware of any problems with the financial statements. It is also essential to realise that the meaning of ‘true and fair’ is highly subjective and changes over a period of time.

### Activity 14.5

*Looking back through Chapters 8 to 12, identify matters of accounting practice where more than one accounting policy is permitted. If you were an auditor, how would you decide whether one or other of the permitted choices gave a true and fair view?*

## 14.9 Measurement of value

Throughout the majority of this financial accounting text the value of assets and liabilities has been measured at historical cost. That means the price paid, or the liability agreed, when the transaction was first undertaken. In times when prices are changing, that information about the cost at the date of the transaction will become less **relevant** to the needs of users (although it may be seen as a **reliable** measure). The IASB Framework says relatively little about measurement,<sup>25</sup> perhaps because of the difficulties of obtaining international agreement. Consequently this section refers to the UK ASB's Statement of Principles where the ideas have been developed further.

### 14.9.1 Stages of recognition and measurement

At the moment when the transaction takes place, the historical cost is also the current value, where current value is regarded as the value of the item at the accounting date. In the *Statement of Principles* this is identified as the point of initial recognition. If an asset or a liability is involved, then there will be various points at which it may be appropriate to remeasure the amount at which the asset or liability is recorded. This is referred to as subsequent remeasurement. Finally there may come a point at which the asset or liability should be removed from the financial statements. This is referred to as derecognition.<sup>26</sup>

The conditions to be applied in deciding on initial **recognition** have been explained in Chapter 2. **Derecognition** reverses the conditions so that an asset or a liability should cease to be recognised if there is no longer sufficient evidence that the entity has access to future economic benefits or an obligation to transfer economic benefits.<sup>27</sup>

### 14.9.2 Limitations of historical cost accounting

Throughout this text you have studied historical cost accounting where the acquisition of assets is recorded at the amount paid at the time of acquisition. The academic literature is bursting at the seams with criticisms of historical cost accounting, but the practice has proved hard to change. There were brief practical attempts in the UK to apply a different approach for a period from the mid-1970s to the mid-1980s but the rate of inflation then became less of a problem and interest waned.

Critics of historical cost accounting have said that in the balance sheet there is the addition of items bought at different times and with £s of different purchasing power. That is not a satisfactory procedure. In the profit and loss account the costs are matched against revenue without regard for the fact that goods were bought and expenses paid for at an earlier point in time. Sales are therefore matched against outdated costs. The tax system takes the accounting profit as its starting point and therefore the tax payable is dictated by outdated accounting figures.

Supporters of historical cost accounting point to its reliability and objectivity because the monetary amount of the transaction is known. Verifiability is straightforward because documentation exists. The preference for historical cost values remains strong; if companies do decide to revalue fixed assets then the ASB requires them to keep the current values up to date in each year's balance sheet.<sup>28</sup>

### 14.9.3 Subsequent remeasurement

Subsequent remeasurement poses more problems and is one of the more controversial aspects of the *Statement of Principles*. It is suggested that there should be a change in the amount at which an asset or liability is recorded if there is sufficient evidence that: (a) the amount has changed and (b) the new amount can be measured with sufficient

reliability.<sup>29</sup> In times of inflation (when prices generally are increasing), the idea of remeasurement becomes particularly important. Even when inflation is not a major problem, there may be one particular asset whose value increases through scarcity of supply or decreases through lack of demand.

That leads into an extremely controversial question: 'How do you measure value?' Chapter 6 of the *Statement of Principles* outlines some approaches to value. Methods of valuation are also listed in the *IASB Framework*.<sup>30</sup>

#### 14.9.4 Entry price and exit price

Taking fixed assets and stocks as the main examples to begin with, it could be said that there are two different categories of measures of value. There is a price which the organisation will have to pay to acquire the asset and there is a price at which the organisation will be able to sell the asset to someone else. If you have ever tried buying and selling second-hand goods you will know that the buying price and the selling price are often quite different. The student who tries to sell an outdated personal computer through an advertisement on the college noticeboard knows that any enquirer will try to push the price downwards. The student attempting to enquire about a similar item of equipment knows that the seller will try to keep the price high. Somehow the price for which you are able to sell your second-hand possessions invariably appears to be lower than the price someone else is asking for their unwanted belongings.

The price paid by a business to acquire an asset is called in accounting the **entry price** and the price at which the business would be able to sell the asset is called the **exit price**. Academic authors will argue long and hard on both sides of the case and if you pursue the study of accounting further you will meet that academic debate. In the real world a decision has to be made. In the UK, that decision was made by the standard-setting body at the beginning of the 1980s, when SSAP 16 required companies to use the entry price approach and to measure the value of fixed assets and stocks at the cost of replacement at the balance sheet date.<sup>31</sup> That approach was used to provide additional information in annual reports of the UK for the first half of the 1980s, but gradually the enthusiasm of companies waned and by the late 1980s they had reverted to their traditional practice of using primarily historical cost for most aspects of measurement.

#### 14.9.5 Current values

In a current value system, changes in value are recorded as they occur. This idea, if accepted, puts quite a large hole in the concept of **realisation**, which is at the heart of traditional accounting practice. It has been the practice to record changes in ownership interest only when the change in an asset or liability is realised, in the form either of cash or of other assets the ultimate realisation of which can be assessed with reasonable certainty.<sup>32</sup> That practice finds support in the Companies Act 1985 which states that the profit and loss account may report only those profits which are realised.

Chapter 12 has explained how the Statement of changes in equity in the IASB system and the Statement of total recognised gains and losses in the UK ASB system both provide the location for reporting changes in assets and liabilities which are not. There is therefore a place in which to report changes in current value, but the question of how to measure value is still unanswered.

The argument favoured by the UK ASB, as indicated in the *Statement of Principles*, is the one which leads to a measurement system based on **value to the business**. Those who support this idea start by asking: What is the worst that can happen to a person, or business, which owns a fixed asset or item of trading stock? The answer is that they may be deprived of the item, perhaps by theft, fire, obsolescence or similar cause. The next question is: What would the owners need in order to be returned to the position they enjoyed previously? The answer, in most cases, is that they need to be provided

with the cost of replacement of a similar item so that they may continue with the activity of the business. In a few rare cases, where the owners may have decided to sell rather than continue using the asset, the selling price is the measure of deprival.

From this analysis it is argued that the value to the business of a fixed asset or an item of stock is usually the **replacement cost** at the accounting date. The replacement cost is that of a similar item in a similar state. Such a replacement cost might be found in a catalogue of prices of used equipment or it could be estimated by starting with the cost of a new item and applying an appropriate proportion of depreciation.

### 14.9.6 Fair value

The IASB standards have moved towards a fair value approach to valuation rather than a deprival value approach. Several of the standards in the IASB system permit or require the use of **fair value**.

#### Definition

**Fair value** is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

In this definition, a fair value does not require an active market to exist although the presence of an active market may make it easier to decide on a fair value. If an active market does not exist then the IASB standards give guidance which depends on the nature of the asset or liability. For property, plant and equipment<sup>33</sup> the suggestion is to use depreciated replacement cost where market-based evidence is not available. For biological assets a range of suggestions is given such as market price of similar assets or discounted present values of future cash flows.<sup>34</sup>

The IASB's view of fair value, which is closer to the **exit value** approach, also favoured by the Financial Accounting Standards Board (FASB) in the USA.

### 14.9.7 Current practice

In annual reports of UK companies there is a general adherence to historical cost but some companies show evidence of using revaluation, which is permitted by the UK ASB as well as by the IASB system.

The International Accounting Standard IAS 16 permits entities to choose either the cost model or the revaluation model. Under the cost model, property, plant and equipment are carried at cost less accumulated depreciation. Under the revaluation model an item of property, plant and equipment may be carried at a revalued amount. The revalued amount is fair value less accumulated depreciation. Revaluations must be made regularly so that the carrying amount remains close to fair value at the balance sheet date.

#### Activity 14.6

*Look at the items you possess. These might include a house or a flat or a car but equally well they could be a bicycle and some modest items of furniture. Whatever their nature, write down on a piece of paper a figure in £s which answers the question: What is the value of these possessions? Now think about how you arrived at that figure. Did you use the original cost because that was the amount you paid to acquire them? Did you use replacement cost because that is the amount you would have to pay to replace them? Did you use selling price because that is the amount you could collect in cash for conversion to other uses? Did you have some other method? What was the reason for the method you chose? Would you obtain the same answer using all the methods listed for this activity? Which answer is the most relevant for your information needs? Which is the most reliable? Is there any conflict here between relevance and reliability? Would other students answer these questions as you have done?*

## 14.10 Developing issues: How valid is the stakeholder model?

This book takes as its starting point the IASB's *Framework*, and has constantly returned to that *Framework* for explanation or discussion of the accounting practices explained in various chapters. The *Framework* is, in its turn, built on a model which sees the objective of accounting as serving the needs of a wide range of users. Those users are sometimes referred to as **stakeholders** and the *Framework* is regarded as an example of a stakeholder model of the process of regulating accounting.

There are, however, those who would argue that the stakeholder model is the wrong place to start and therefore the significant problems of accounting will not be solved using a statement of principles of this type. At the basic level of understanding existing accounting practice, which is the limit of this book, the validity of one model versus another may not be a critical issue, but you should be aware that there are views that more complex accounting problems may not be solved using a stakeholder approach (although the ASB might not subscribe to such views).

Those who argue against the 'user needs' approach suggest that accounting regulation is a much more complex process of social interaction. Standard setters producing accounting rules in a self-regulatory environment need to be sure of a consensus of opinion supporting the proposed rules. They will therefore seek out a range of opinions and will undoubtedly be subjected to lobbying (letters of comment and personal contact) by persons or organisations seeking to put forward a particular viewpoint. Indeed, part of the UK standard-setting process involves issuing an exposure draft for comment before a financial reporting standard is issued, although there is no way of knowing what lobbying occurs behind the scenes.

The process of standard setting may therefore be regarded as one of negotiating and balancing various interests. There has been research after the event, both in the UK and in other countries, which has shown that the standard-setting bodies were influenced by one or more powerful forces. One particularly clear example may be seen in the development of an accounting standard to tighten up practices in reporting expenditure on research and development.<sup>35</sup> There is a significant amount of academic literature on factors influencing the process of setting accounting standards.

Those who have identified these 'political' pressures would suggest that the accounting standard-setting process should openly admit that there are influential factors such as: the relative balance of power among those who prepare and those who use accounting information; relative dependency of some on others; the balance of individual liberty against collective need; and the ideology observed in particular systems of social relations. (Ideology means that a group in society may hold strong beliefs which make it genuinely unable to appreciate different positions taken by others.)

Thus claims that the standard-setting process is neutral in its impact on the economy or on society may be unrealistic. This book does not seek to impose any particular view on its readers. It has used the *Framework* as a consistent basis for explaining current practice, but it leaves to the reader the task of taking forward the knowledge of external financial reporting and the understanding of what influences the future development of external financial reporting.

## 14.11 Summary

- The **operating and financial review** (OFR) provides a balanced and comprehensive analysis of the business, its year-end position, the trends in performance during the year and factors likely affect future position and performance. It is good practice for quoted UK companies.

- A **highlights** statement in the annual report shows what the company regards as important information for investors as the primary users of the annual report. A table of five-year trends is also useful in evaluating the position and performance of the business.
- **Segmental reporting** has developed as a means of supplementing the consolidated financial statements by providing more insight into the activities of the group. In particular it reports information about the different types of produces and services that an entity produces and the different geographical areas in which it operates.
- **Off-balance-sheet finance** describes the situation where an asset and a liability are omitted from the financial statements of an entity. The UK ASB takes the view that such transactions should remain on the entity's balance sheet if the risks and rewards remain with the entity. The IASB has specific rules to deal with special purpose vehicles, which are one form of off-balance sheet finance.
- **Corporate social responsibility** means that companies integrate social and environmental concerns in their business operations and in their interactions with stakeholders. Many companies include social and environmental disclosures in their annual reports. The Global Reporting Initiative provides a framework for such disclosures.
- Carbon trading, arising from the Kyoto Protocol, provides a new form of asset in the licence to emit carbon dioxide and a new form of liability in the obligation to reduce emissions.
- The term **corporate governance** is used to describe the way in which companies are directed and controlled. Listed companies in the UK are required to follow the Combined Code of Corporate Governance. In the annual report the directors must either confirm compliance with the Code or explain reasons for non-compliance.
- Directors' remuneration is one aspect of corporate governance that receives a great deal of attention. There are rules and guidance on the disclosure of remuneration (pay) policy and the amount due to each director. The information is usually contained in the report of the Remuneration Committee.
- The IASB system of accounting requires financial statements to **present fairly** the financial position, financial performance and cash flows of an entity. The Companies Act 1985 requires that financial statements of companies should show a **true and fair view**. The Financial Reporting Council has given an opinion that the two phrases are broadly equivalent.
- There is a continuing debate on the methods of measuring assets and liabilities. **Reliability** points towards historical cost accounting but **relevance** points towards current values.
- **Entry price** values are values that measure the cost of buying, acquiring or replacing an asset or liability. **Exit price** values represent the sale, disposal or other form of realisation of an asset.
- **Fair value** is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
- Finally, it should be noted that this entire book on financial accounting has been built on a **stakeholder model** of user needs which itself is the basis of the IASB's *Framework*. That idea meets general acceptance in the accounting profession from those who set accounting standards, but you need to be aware that further study of the academic literature will encourage you to question the user needs model.

## Further reading

Gray, R. and others (1998) *Valuation of Assets and Liabilities: Environmental Law and the Impact of the Environmental Agenda on Business*, The Institute of Chartered Accountants of Scotland.

Parker, R. H. and Nobes, C. W. (1994) *An International View of True and Fair Accounting*, Routledge.

*Testimony Concerning Recent Events Relating to Enron Corporation*, by Robert K. Herdman, Chief Accountant, US Securities and Exchange Commission, before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises and the Subcommittee on Oversight and Investigation, Committee on Financial Services, US House of Representatives. [www.sec.gov/news/testimony/121201tsrk.htm](http://www.sec.gov/news/testimony/121201tsrk.htm)

The development of the Operating and Financial Review can be traced on the website of the Department of Trade and Industry (DTI), UK Company Law Review, [www.dti.gov.uk](http://www.dti.gov.uk)

## QUESTIONS

The Questions section of each chapter has three types of question. 'Test your understanding' questions to help you review your reading are in the 'A' series of questions. You will find the answers to these by reading and thinking about the material in the book. 'Application' questions to test your ability to apply technical skills are in the 'B' series of questions. Questions requiring you to show skills in problem solving and evaluation are in the 'C' series of questions. A letter [S] indicates that there is a solution at the end of the book.

### A Test your understanding

- A14.1** What is the objective of the operating and financial review? (Section 14.2.1)
- A14.2** Why is there no prescribed format for the OFR? (Section 14.2.2)
- A14.3** What are the main principles set by the ASB for the OFR? (Section 14.2.2)
- A14.4** What are the main elements of the disclosure framework for the OFR? (Section 14.2.3)
- A14.5** What are key performance indicators (KPIs)? (Section 14.2.4)
- A14.6** What are the particular requirements of the OFR Regulation that must be reported in an OFR? (Section 14.2.5)
- A14.7** What are the responsibilities of the directors and auditors in relation to the OFR? (Section 14.2.6)
- A14.8** What is the purpose of a highlights statement? (Section 14.3.1)
- A14.9** How does a five-year summary of historical results help investors? (Section 14.3.2)
- A14.10** How does segmental information help the users of financial statements? (Section 14.4.1)
- A14.11** Which items are reported on a segmental basis? (Section 14.4.1)
- A14.12** How are segments identified? (Section 14.4.3)
- A14.13** Why is off-balance-sheet finance a problem in accounting? (Section 14.5)
- A14.14** What principles are recommended by the UK ASB for determining whether assets and liabilities should be reported on the balance sheet? (Section 14.5.2)
- A14.15** What is a special purpose entity? (Section 14.5.3)

- A14.16** What is corporate social responsibility? (Section 14.6)
- A14.17** What is the Global Reporting Initiative? (Section 14.6.3)
- A14.18** What accounting issues arise in relation to carbon trading? (Section 14.6.4)
- A14.19** What is meant by corporate governance? (Section 14.7)
- A14.20** What is the Combined Code? (Section 14.7.1)
- A14.21** How does financial reporting help to improve corporate governance? (Section 14.7)
- A14.22** Why has it been found impossible to write a definitive guide on the meaning of 'a true and fair view'? (Section 14.8)
- A14.23** What are the limitations of historical cost accounting? (Section 14.9.2)
- A14.24** Why is it desirable to remeasure assets and liabilities subsequent to acquisition? (Section 14.9.3)
- A14.25** Explain what is meant by **entry price** and **exit price**. (Section 14.9.4)
- A14.26** Explain what is meant by fair value. (Section 14.9.6)
- A14.27** Should accounting standards focus primarily on the needs of users? (Section 14.10)

## B Application

### B14.1

Suggest, with reasons, three KPIs for each of the following types of business, and explain why it is unlikely that two businesses will choose identical KPIs.

- a private hospital
- a car repair garage
- a clothing manufacturer.

## C Problem solving and evaluation

### C14.1 [S]

Carry out a trend analysis on Safe and Sure plc, using the historical summary set out in Appendix I. Write a short report on the key features emerging from the trends.

## Activities for study groups

### Case 14.1

Turn to the annual report of a listed company which you have used for activities throughout the previous chapters. Split the group to take two different roles: one half of the group should take the role of the finance director and the other half should take the role of the broker's analyst writing a report on the company.

Look through the annual report for any ratio calculations performed by the company and check these from the data in the financial statements, so far as you are able. Prepare your own calculations of ratios for analysis of all aspects of performance. Find the current share price from a current newspaper.

Once the data preparation is complete, the finance director sub-group should prepare a short report to a meeting with the analysts. The analysts should then respond with questions arising from the ratio analysis. The finance directors should seek to present answers to the questions

using the annual report. Finally write a short report (250 words) on problems encountered in calculating and interpreting financial ratios.

### Case 14.2

Turn to the annual report of a listed company which you have used for activities in previous chapters. Is this a group? How do you know? Where is the list of subsidiary companies?

If you do not have a group report, obtain another annual report which is for a group of companies (nearly all large listed companies operate in group form). As a group, imagine that you are a team of analysts seeking to break down the component segments of the group for analytical purposes. How much information can you find about the segments? What are the problems of defining segments in this group? If you can obtain the annual report for the previous year, compare the definitions of segments. Are they consistent from one year to the next?

Based on your analysis, prepare a short essay (250 words): 'The usefulness of segmental information in the analysis of group performance'.

### Case 14.3

Divide the group into sections to take on four different roles: a private shareholder in a company; a financial journalist; a finance director of a company; and a broker's analyst providing an advisory service to clients.

In each section develop your opinion on the subject: *Taking the user needs perspective will solve all the problems of accounting.*

Arrange a meeting to present all four opinions and then discuss the extent to which the International Accounting Standards Board will be able to obtain the co-operation of all parties in solving accounting problems.

## Notes and references

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4. ASB (2005), RS 1 para. 1.
5. ASB (2005), RS 1 paras. 5, 7, 9, 14, 17, 23 and 25.
6. ASB (2005), RS 1 para. 28.
7. ASB (2005), RS 1 paras. 29 and 30.
8. IASB (2004), IAS 14 *Segment reporting* International Accounting Standards Board.
9. IASB (2004) IAS 14 para. 26.
10. ASB (1994), Financial Reporting Standard (FRS 5), *Reporting the Substance of Transactions*, Accounting Standards Board.
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12. *The Committee on Corporate Governance Final Report* (1998), Gee Publishing Ltd. (The Committee chairman was Sir Ronnie Hampel.)
13. Hampel Report, Principle DI.
14. *Report of a Study Group on Directors' Remuneration* (1995) (The Greenbury Report), Gee Publishing Ltd.
15. IASB (2004), IAS 1 *Presentation of financial statements*, para. 13.
16. IASB (2004) IAS 1 para. 15.
17. IASB (2004) IAS 1 para. 16.
18. IASB (2004) IAS 1 paras. 17 and 18.
19. Companies Act 1985, sections 226 and 227.
20. FRC, 9 August 2005, *The implications of new accounting and auditing standards for the 'true and fair view' and auditors' responsibilities*. Financial Reporting Council website [www.frc.org.uk](http://www.frc.org.uk)
21. IASB Framework, para. 46.
22. Hoffman, L. and Arden, M. H. (1983) 'Legal opinion on "true and fair"', *Accountancy*, November, pp. 154–6.
23. ASB (1993), *Foreword to Accounting Standards*, appendix, 'Accounting Standards Board: the true and fair requirement', para. 4. Opinion prepared by Mary Arden, barrister of Erskine Chambers, Lincoln's Inn, London.

24. *Ibid.*, para. 14.
25. IASB *Framework*, paras. 99–101.
26. ASB (1999), *Statement of Principles for Financial Reporting*, ch. 5, 'Recognition in financial statements', paras 5.22–5.25.
27. *Ibid.*, para. 5.23.
28. ASB (1999), Financial Reporting Standard (FRS 15), *Measurement of Tangible Fixed Assets*, Accounting Standards Board, paras 43–52.
29. *Ibid.*, para. 6.19.
30. IASB *Framework*, para. 100.
31. ASC (1980), Statement of Standard Accounting Practice (SSAP 16), *Current Cost Accounting*, Accounting Standards Committee (issued March 1980 and withdrawn July 1988).
32. ASB (2000), Financial Reporting Standard (FRS 18), *Accounting Policies*, para. 28, Accounting Standards Board.
33. IASB (2004) IAS 16 *Property, plant and equipment*, para. 33.
34. IASB (2004) IAS 41 *Agriculture*, paras. 13–25.
35. Hope, T. and Gray, R. (1982) 'Power and policy making: the development of an R&D standard', *Journal of Business Finance and Accounting*, 9 (4), pp. 531–58.