

Chapter 4

Ensuring the quality of financial statements

REAL WORLD CASE

2004/05 Group highlights

		Reported basis	At constant exchange rates ⁽¹⁾⁽²⁾
Like for like sales		up 5.0%	
Sales	£1,614.4m	up 0.6% ⁽²⁾	up 7.8%
Operating profit	£218.9m	up 4.1% ⁽²⁾	up 11.3%
Profit before tax	£210.3m	up 5.3% ⁽²⁾	up 12.1%
Earnings per share ⁽³⁾	8.2p	up 9.3% ⁽²⁾	up 15.5%
Dividend per share	3.0p	up 20.0%	
Return on capital employed ⁽³⁾	26.5%	up from 25.9% ⁽²⁾	
Gearing ⁽³⁾	11.3%	down from 11.8% ⁽²⁾	

(1) See page 29 for reconciliation to Generally Accepted Accounting Principles ('GAAP') figures.

(2) 2000/01 to 2003/04 restated for the implementation in 2004/05 of the amendment to FRS 5, 'Application Note G – Revenue Recognition'.

(3) Earnings per share, return on capital employed and gearing are defined on page 130.

(4) 53 week year.



Introduction

The key drivers of operating profitability are the:

- rate of sales growth,
- balance between like for like sales growth and sales from new store space,
- achieved gross margin,
- level of cost increases experienced by the Group,
- level of net bad debt charge relating to the in-house credit card in the US, and
- movements in the US dollar to pound sterling exchange rate, since the majority of the Group's profits are generated in the US and the Group reports in pounds sterling.

Source: Signet Group plc Annual Report and Accounts 2005, inside cover and p. 24.

Discussion points

- 1 How does the company present the information it regards as most relevant to the needs of readers?
- 2 The group provides information 'at constant exchange rates' to eliminate the effects of exchange rate fluctuations. How relevant is this information to the needs of users?

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Learning outcomes

After studying this chapter you should be able to:

- List and explain the qualitative characteristics desirable in financial statements.
- Explain the approach to measurement used in financial statements.
- Explain why there is more than one view on the role of prudence in accounting.
- Understand and explain how and why financial reporting is regulated or influenced by external authorities.
- Be aware of the process by which financial statements are reviewed by an investor.

4.1 Introduction

The previous chapter used the accounting equation as a basis for explaining the structure of financial statements. It showed that design of formats for financial statements is an important first step in creating an understandable story from a list of accounting data.

The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.¹

Information about financial position is provided in a **balance sheet**. Information about performance is provided in an **income statement** (profit and loss account).² Information about changes in the cash position is provided in a **cash flow statement**. These three statements were explained in outline in Chapter 3. Information about changes in financial position is also provided in a separate statement, described in Chapter 12. Notes to the financial statements provide additional information relevant to the needs of users. These notes may include information about risks and uncertainties relating to assets, liabilities, revenue and expenses.³

4.2 Qualitative characteristics of financial statements

The IASB *Framework* sets out qualitative characteristics that make the information provided in financial statements useful to users. The four principal qualitative characteristics are:

- understandability
- relevance
- reliability
- comparability.⁴

The principal qualitative characteristics of relevance and reliability have further sub-headings, as follows:

- relevance
 - materiality
- reliability
 - faithful representation
 - substance over form
 - neutrality
 - prudence
 - completeness.

Each of these characteristics is now described.

4.2.1 Understandability

It is essential that the information provided in financial statements is readily **understandable** by users.⁵ Users are assumed to have a reasonable knowledge of business and economic activities and accounting, and a willingness to study the information with reasonable diligence. Information on complex matters should not be omitted from financial statements merely on the grounds that some users may find it difficult to understand.

4.2.2 Relevance

Information has the quality of **relevance** when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.⁶

Information has a predictive role in helping users to look to the future. Predictive value does not necessarily require a forecast. Explaining unusual aspects of current performance helps users to understand future potential. Information also has a confirmatory role in showing users how the entity has, or has not, met their expectations.⁷

Materiality

Information is **material** if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement.⁸

The IASB *Framework* takes the view that materiality is a cut-off point in deciding whether information is important to users. The description of an item may make it material. The amount of an item may make it material.

For example, the balance sheet of a business shows inventories of raw materials and inventories of finished goods as two separate items. That is because the users of financial statements are interested in the types of inventory held as well as the amount of each. The risks of holding raw materials are different from the risks of holding finished goods. However the inventory of finished goods is not separated into the different types of finished goods because that would give too much detail when the risks of holding finished goods are relatively similar for all items.

4.2.3 Reliability

Information has the quality of **reliability** when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent.⁹

Information may be relevant but so unreliable that it could be misleading (e.g. where a director has given a highly personal view of the value of an investment). On the other hand, it could be reliable but quite non-relevant (e.g. the information that a building standing in the centre of a major shopping street was bought for 50 guineas some 300 years ago).

Faithful representation

Faithful representation is important if accounting information is to be reliable. Faithful representation involves the words as well as the numbers in the financial statements. Sometimes it may be difficult for the managers of an entity to find the right words to describe a transaction and convey the problems of making reliable measurement. In such cases it will be important to disclose the risk of error surrounding recognition and measurement.¹⁰

Substance over form

If information is to meet the test of faithful representation, then the method of accounting must reflect the **substance** of the economic reality of the transaction and not merely its **legal form**.

For example, a company has sold its buildings to a bank to raise cash and then pays rent for the same buildings for the purpose of continued occupation. The company carries all the risks and problems (such as repairs and insurance) that an owner would carry. One view is that the commercial substance of that sequence of transactions is

comparable to ownership. Another view is that the legal form of the transaction is a sale. The characteristic of substance over form requires that the information in the financial statements should show the commercial substance of the situation.¹¹

Neutrality

The information contained in financial statements must be **neutral**. This is also described as being 'free from bias'. Financial statements are not neutral if, by the selection and presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.¹²

This condition is quite difficult to enforce because it has to be shown that the entity producing the financial statements is trying to influence the decisions or judgements of all members of a class of users of the information. It would be impractical to know the decision-making process of every individual user.

Prudence

The preparers of financial statements have to contend with uncertainty surrounding many events and circumstances. The existence of uncertainties is recognised by the disclosure of their nature and extent and by the exercise of **prudence** in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that gains and assets are not overstated and losses and liabilities are not understated.¹³

Completeness

It almost goes without saying that information cannot be reliable if it is not **complete**. The information in financial statements must be complete, within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus to lack reliability and relevance.¹⁴

4.2.4 Comparability

Comparability means that users must be able to compare the financial statements of an enterprise over time to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different enterprises to evaluate their relative financial position, performance and changes in financial position.¹⁵ Financial statements should show corresponding information for the previous period.¹⁶

Consistency

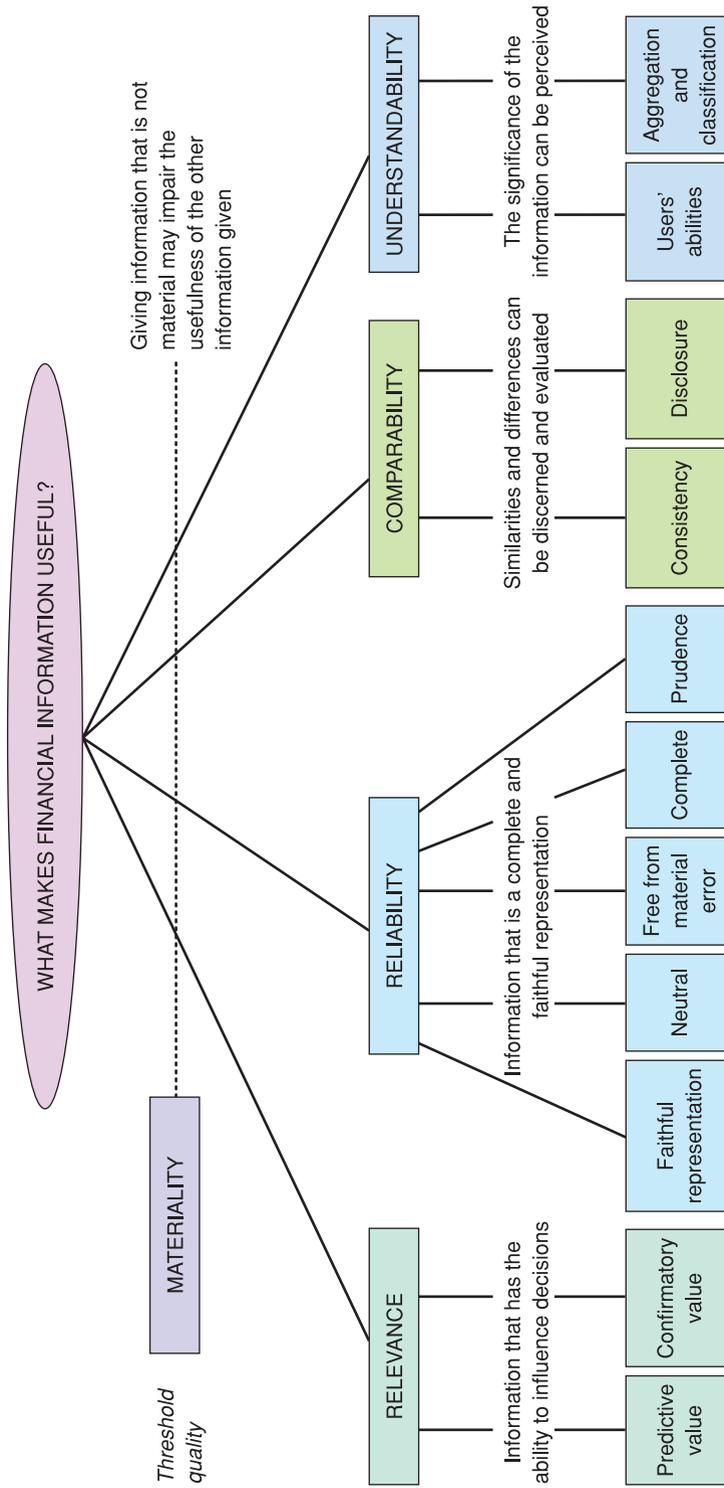
This concerns the measurement and display of the financial effect of like transactions and other events being carried out in a consistent way throughout an entity within each accounting period and from one period to the next, and also in a consistent way by different entities.¹⁷

However, the need for **consistency** should not be allowed to become an impediment to the introduction of improved accounting practices. Consistency does not require absolute uniformity.¹⁸

Disclosure of accounting policies

This is another important aspect of **comparability**. **Disclosure** means that users of financial statements must be informed of the accounting policies employed in the preparation of financial statements. Managers must also disclose changes in accounting policies and the effect of those changes.¹⁹

Exhibit 4.1
UK ASB: Relationships of the qualitative characteristics of financial information



Source: ASB (1999), *Statement of Principles for Financial Reporting*, p. 34. Reproduced with the permission of the Accounting Standards Board.

The annual report of a company will usually have a separate section headed 'Accounting policies'. It will be located immediately after the primary financial statements, leading into the detailed notes to the accounts. The statement of accounting policies is essential reading for any user of the annual report.

4.2.5 Constraints on relevant and reliable information

Relevance and **reliability** are twin targets which may cause some tension in deciding the most appropriate way to report accounting information. There is a trade-off between relevance and reliability when it comes to ensuring that information is delivered in a timely manner so that it is still relevant, and when it comes to deciding whether the costs of producing further information exceed the benefits.

Timeliness

If information is provided in a timely way, the reliability may be less than 100% because some aspects of a transaction are not yet complete. If reporting is delayed until all aspects of a transaction are known then the relevance may be less than 100% because investors have become tired of waiting. The balance of **timeliness** is achieved by considering how best to serve the needs of users in making economic decisions.²⁰

Benefit and cost

The benefits derived from information should be greater than the costs of providing it. The analysis is complicated because the benefits fall mainly on the users, while the costs fall mainly on the provider. It is important for standard-setters to consider the benefits and costs as a whole.²¹

4.2.6 UK ASB

The UK ASB's representation of the relationships between the various qualitative characteristics is set out in Exhibit 4.1.²²

In many ways the ideas of the UK ASB reflect those of the IASB which were written ten years earlier. However during that ten-year period the ASB had time to benefit by thinking about ways of clarifying some aspects of the IASB's ideas. One difference in presentation is that the ASB suggests that materiality is a test to be applied at the threshold of considering an item. If any information is not material, it does not need to be considered further.

Activity 4.1

Look back to Exhibit 4.1. Is there any aspect of that diagram which came as no surprise to you? Is there any aspect of that diagram which was a surprise to you? Having read the explanations in this section, do you hold the same surprise that you did at the outset? With the benefit of hindsight, can you explain why you were surprised or not surprised? Has this analysis caused you to modify your own objectives for what you hope to learn from this book?

4.3 Measurement in financial statements

You have seen in Chapter 2, sections 2.5 and 2.8, that the recognition of assets and liability requires reliability of measurement. You have seen in Chapter 3 the methods of presentation of accounting information containing numbers that represent measurement. We now need to know more about the accounting measurement principles

that establish reliability and about the disclosure of information that allows users of financial statements to understand the measurement process.

The accounting measurement principles that are most widely known in the UK are found within the Companies Act 1985.²³

- going concern
- accruals
- consistency
- prudence.

The IASB *Framework* describes the accrual basis and going concern as ‘underlying assumptions’ in the preparation of financial statements. It describes **prudence** as a ‘constraint’ on relevance and reliability. Consistency is an aspect of comparability.

4.3.1 Going concern

Definition

The financial statements are normally prepared on the assumption that an entity is a **going concern** and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.²⁴

The UK Companies Act statement on **going concern** is rather like a crossword clue, in being short and enigmatic. It states: ‘The company shall be presumed to be carrying on business as a going concern.’ More guidance is needed on measurement.

For companies applying UK accounting standards there is guidance in FRS 18. It requires an entity to prepare its financial statements on a going concern basis unless the entity is being liquidated or has ceased trading, when a ‘break-up’ valuation may be more appropriate. On a forced sale, very little is obtained for the assets of a business. If the company is still operating but the directors are aware of conditions that cast doubts on the company’s ability to continue as a going concern, they should disclose those uncertainties. They must take into account all available information about the ‘foreseeable future’.

If the company is staying in business then the directors are allowed to use valuations that reflect continuity. They do not have to report ‘break-up’ values, which are values for immediate sale of assets. Investors are probably quite happy when the company is continuing as a going concern. They will be more concerned about the risk that it will not continue. For that reason, the directors are required to make a statement in their report to confirm that the business remains a ‘going concern’ for the foreseeable future. There is no readily available definition of ‘foreseeable future’ but the guidance given in the UK to directors and auditors points towards considering a period of 12 months from the balance sheet date.

4.3.2 Accruals (also called ‘matching’)

Definition

Under the **accruals** basis, the effects of transactions and other events are recognised when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.²⁵

The IASB explains that financial statements prepared on the accruals basis are useful for stewardship purposes because they report past transactions and events but are also

helpful to users for forward-looking information because they show obligations to pay cash in the future and resources that represent cash to be received in the future.

The UK Companies Act explains the accruals concept as a requirement that all income and charges (i.e. expenses) relating to the financial year shall be taken into account, without regard to the date of receipt or payment.

The word 'accrue' means 'to fall due' or 'to come as a natural result'. If, during a year, a company sells £100m of goods but collects only £80m from customers, it records sales as £100m in the profit and loss account. The cash yet to be collected from customers is reported as an asset called 'debtor' in the balance sheet. If, during the year, it uses electricity costing £50m but has only paid £40m so far, it records the expense of £50m in the profit and loss account. The unpaid electricity bill is reported as a liability called 'accruals' in the balance sheet.

The idea of matching is also used in applying the idea of accruals. Matching has two forms, matching losses or gains against time and matching expenses against revenue. Time matching occurs when a gain or loss is spread over the relevant period of time, such as receiving interest on a loan or paying rent on a property. Matching of revenues and expenses occurs when costs such as labour are matched against the revenue earned from providing goods or services.

4.3.3 Consistency

Consistency is described in the IASB *Framework* as an aspect of comparability (see section 4.2.4). The UK Companies Act requires that accounting policies shall be applied consistently within the same accounts and from one period to the next.

4.3.4 Prudence

The Companies Act does not define prudence but uses the word prudent in relation to measurement. It requires that the amount of any item shall be determined on a prudent basis, and in particular:

- (a) only profits realised at the balance sheet date shall be included in the profit and loss account; and
- (b) all liabilities and losses which have arisen or are likely to arise in respect of the financial year shall be taken into account, including those which only become apparent between the balance sheet date and the date on which it is signed by the board of directors.

The UK ASB has said that decisions about recognition of income or assets and of expenses or liabilities require evidence of existence and reliability of measurement. Stronger evidence and greater reliability of measurement are required for assets and gains than for liabilities and losses.²⁶

4.3.5 Realisation

There is no clear statement of the conditions that will make a profit **realised**. It is not specifically defined in the IASB system. It is an example of an idea that is so widely used that it appears to be almost impossible to explain. If you turn to a dictionary you will find 'realise' equated to 'convert into cash'. The accounting standard FRS 18²⁷ confirms that it is the general view that profits shall be treated as realised when evidenced in the form of cash or other assets whose cash **realisation** is reasonably certain. However, the standard avoids linking realisation to 'prudence', explaining that a focus on cash does not reflect more recent developments in financial markets. Evidence of 'reasonable certainty' in such markets does not necessarily require cash. It is based on confidence in the reliable operation of the market.

Activity 4.2

Take a piece of paper having two wide columns. Head the left-hand column 'My thoughts on measurement in accounting' and head the right-hand column 'What the book tells me about measurement'. Fill in both columns and then exchange your paper with a fellow student. Discuss with each other any similarities and differences in the left-hand column and relate these to your personal views and prior experience. Discuss with each other any similarities and differences in the right-hand column and evaluate the extent to which different people see books differently. Finally, discuss with each other the extent to which reading this section has changed your views on measurement as a subject in accounting.

4.4 Views on prudence

The Companies Act makes an explicit link between prudence and realisation that reflects UK accounting practice when the Companies Act was written. The IASB's *Framework* avoids mentioning realisation and describes prudence in terms of 'a degree of caution'.²⁸ From the UK ASB, the standard FRS 18 acknowledges the meaning of realisation but breaks the link between realisation and prudence.²⁹ Because FRS 18 is relatively new, it is not possible to say whether it will change the entrenched conservatism of accounting practice which tends towards understatement on grounds of caution. Where does that leave the student of accounting who wants to understand the meaning of prudence?

The most important message for students of accounting (and for many practitioners) is contained in the IASB's *Framework*:³⁰

... the exercise of prudence does not allow ... the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, not have the quality of reliability.

Why are there different views on understatement and overstatement, depending on the item being reported? Here is your first chance to use the accounting equation to solve a problem:

Assets	minus	Liabilities	equals	Capital contributed/withdrawn plus Profit
Profit		Revenue		minus Expenses

Activity 4.3

Ask yourself what will happen to profit in the accounting equation if the amount of an asset is increased while the liabilities and the capital contributed remain the same. Then ask yourself what will happen to profit in the accounting equation if the amount of a liability is decreased while the assets and the capital contributed remain the same. Next ask yourself what will happen to profit if revenue is overstated. Finally ask yourself what will happen to profit if expenses are understated.

Assuming that capital contributed/withdrawn remains constant, overstating assets will overstate profit. Understating liabilities will overstate profit. Overstating revenue will overstate profit. Understating expenses will overstate profit.

Examples

A market trader buys £100 of stock on credit, promising to pay the supplier at the end of the day. The trader sells three-quarters of the stock at a price of £90 and takes the

rest home to keep for next week's market. At the end of the day the trader has £90 in cash, one-quarter of the stock which cost £25, and owes £100 to the supplier. How much profit has the trader made? The answer is that the profit is £15 (£90 received for the sale of stock less the cost of the items sold, £75, being three-quarters of the stock purchased). The accounting equation is:

Assets minus Liabilities at the end of the period	equals	Ownership interest at the start of the period plus Capital contributed/withdrawn plus Revenue of the period minus Expenses of the period
stock £25 + cash £90 – liability £100	equals	nil + nil + revenue £90 – expenses £75
£15	equals	£15

- 1 Supposing the trader 'forgets' part of the liability and thinks it is only £84 owing, rather than £100. The assets remain at stock £25 + cash £90, which equals £115. The liability is now thought to be £84 and therefore the equation becomes:

£25 + £90 – £84	equals	nil + nil + revenue £90 – expenses £75 + [?] £16 [?]
£31	equals	£31

For the equation to be satisfied there must be a total of £31 on both sides. The total of £31 is therefore written in. The recorded profit is still only £15, calculated as revenue £90 minus expenses £75, so there is a 'hole' amounting to £16 on the right-hand side of the equation. The accounting equation has to balance so the extra £16 is written in, surrounded by question marks, on the right-hand side. It is assumed on the right-hand side that the trader has either forgotten to record revenue of £16 or has recorded too much expense, so that the amount appears to represent an unexplained profit. Thus *understating a liability will overstate profit*. That favourable news might mislead a competitor or investor. It might be bad news when the Inland Revenue demands tax on profit of £31. Also there is the unpaid supplier who may not be entirely patient when offered £84 rather than £100.

- 2 Supposing instead that the trader 'forgets' there is some unsold stock left. The only recorded asset would be the cash at £90 and there would be a liability of £100. This gives negative net assets of (£10) and, because the accounting equation has to balance, suggests that there is a 'forgotten' expense of £25 on the right-hand side. The equation then becomes:

£90 – £100	equals	nil + nil + £90 – £75 – [?] £25 [?]
(£10)	equals	(£10)

This would cause the Inland Revenue to ask a lot of questions as to why there was no record of stock remaining, because they know that omitting stock from the record is a well-tried means of fraudulently reducing profits and therefore reducing tax bills. *Understating an asset will understate profit*.

These two examples have illustrated the meaning of the warning that deliberate understatement or overstatement is not acceptable. The general message of prudence is: *avoid overstating profit*. In down-to-earth terms, don't raise the readers' hopes too high, only to have to tell them later that it was all in the imagination.

4.5 Regulation of financial reporting

Because the external users of accounting information do not have day-to-day access to the records of the business, they rely on the integrity and judgement of management to provide suitable information of a high quality. But will the management be honest, conscientious and careful in providing information? In an ideal world there should be no problem for investors in a company because, as shareholders, they appoint the directors and may dismiss them if dissatisfied with the service provided. However, the world is not ideal. Some companies are very large and they have many shareholders whose identity changes as shares are bought and sold. Over the years it has been found that regulation is needed particularly for financial reporting by companies. The general regulation of companies in the UK is provided by parliamentary legislation, through the Companies Act 1985.

However since 2005 the regulation of financial reporting by UK companies has taken two separate routes depending on the type of company.

The group financial statements of listed companies must comply with the IAS Regulation set by the European Commission. The IAS Regulation takes precedence over the relevant sections of the Companies Act. The IAS Regulation was issued in 2002, requiring listed group financial statements from 2005 to apply approved International Financial Reporting Standards, IFRS (previously called International Accounting Standards, IAS). The UK government subsequently permitted individual companies and non-listed groups to choose to apply IFRS. Any companies not taking up this choice must continue to apply the relevant sections of the Companies Act and follow the accounting standards set by the UK Accounting Standards Board (ASB). Other organisations that are not companies (such as sole traders, partnership, public sector bodies) have to look to the regulations that govern their operations to decide which accounting guidance to follow.

So how can we tell which accounting system has been applied in any situation? Look first for the audit report, if there is one. That will include a paragraph starting 'In our opinion'. In that paragraph the auditors will specify the accounting system on which their opinion is based. If there is no auditors' report, look for the Note on Accounting Policies. There will usually be a paragraph stating the accounting system that has been applied.

4.5.1 The IAS Regulation

In 2002 the European Commission issued the *IAS Regulation* which took effect from 1 January 2005. Its purpose is to harmonise the financial information presented by public listed companies in order to ensure a high degree of transparency and comparability of financial statements. The Regulation is relatively short but has been extended and clarified by a trail of subsequent documents. The European Commission publishes all documents on its website³¹ in the languages of all Member States but that is more detail than is necessary for a first year course.

A Regulation is directly applicable in Member States. It has a higher status than a Directive, which is an instruction to Member States on the content of their national laws. Before the Regulation was issued, the company law of Member States was harmonised by following the Fourth and Seventh Directives on company law. Companies in Member States did not need to know the Directives because the national company law applied the Directives. Now that the IAS Regulation is directly applicable, Member States must ensure that they do not seek to apply to a company any additional elements of national law that are contrary to, conflict with or restrict a company's compliance with IASs.

The Commission decides on the applicability of IFRS within the Community. It is assisted by an Accounting Regulatory Committee and is advised by a technical group called the European Financial Reporting and Accounting Group EFRAG.³² The tests for adoption of IFRS are that the standards:

- (a) do not contradict specific principles of the Fourth and Seventh Directive,
- (b) are conducive to the European public good, and
- (c) meet the criteria of understandability, relevance, reliability and comparability required of financial information needed for making economic decisions and assessing the stewardship of management.

A standard that is adopted is said to be **endorsed**. If a standard is awaiting endorsement, or is rejected, it may be used as guidance if it is not inconsistent with endorsed standards. If a rejected standard is in conflict with adopted standards, it may not be used. When the European Commission first announced the endorsement process there were fears expressed that this would be used to create 'European IFRS' by selecting some IFRS and rejecting others. The Commission's reply was that the EU cannot give its powers to a body (the IASB) that is not subject to EU jurisdiction, and it is necessary for the EU to endorse standards as part of its duty in setting laws for Member States.

4.5.2 UK company law

Companies Act 1985

The Companies Act 1985 sets many rules for investing in and operating companies. Parts of the Act cover the information presented in financial statements. For companies and other organisations that do not follow the IAS Regulation, the Companies Act 1985 prescribes formats of presentation of the balance sheet and profit and loss account. Companies must select one of the permitted formats. It also prescribes methods of valuation of the assets and liabilities contained in the balance sheet, broadly expecting that normally these items will be recorded at their cost at the date of acquisition, subject to diminutions in value since that date. Some other approaches to valuation are permitted, but these are carefully regulated and are subject to requirements for prudence, consistency and an expectation that the business is a going concern (i.e. will continue for some time into the future). The UK legislation places strong emphasis on the requirement to present a **true and fair** view in financial statements.

Since the early 1980s company law on financial reporting has been harmonised with that of other Member States in the EU through the Fourth and Seventh Directives of the EU (*see* Chapter 7).

The directors are responsible for the preparation of company accounts. Exhibit 4.2 sets out the statement made by directors of one major public company regarding their responsibilities in these matters. This type of statement will be found in the annual reports of most of the large listed companies. It is regarded as an important aspect of giving reassurance to investors and others that there is a strong system of corporate governance within the company. It is also intended to clarify any misunderstandings the shareholders may have about the work of directors as distinct from the work of the auditors (*see* below).

The Companies (Audit, Investigations and Community Enterprise) Act, 2004 made changes intended to improve the reliability of financial reporting, the independence of auditors and disclosure to auditors. In particular it required a statement to be inserted in the directors' report confirming that there is no relevant information that has not been disclosed to the auditors. The role of the Financial Reporting Review Panel was strengthened by giving it new powers to require documents. HM Revenue and Customs was authorised to pass information about companies to the FRRP.

Exhibit 4.2**Statement of directors' responsibilities as expressed in the annual report of a public limited company****Statement of directors' responsibilities**

Company law requires the directors to prepare accounts for each financial year which give a true and fair view of the state of affairs of the company and of the group and of the profit or loss and cash flows of the group for that period. In preparing these accounts, the directors have adopted suitable accounting policies and then applied them consistently, made judgements and estimates that are reasonable and prudent, followed applicable accounting standards and adopted the going concern basis.

The directors are responsible for ensuring that the company keeps proper accounting records which disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that the accounts comply with the IAS Regulation/Companies Act 1985. They are also responsible for safeguarding the assets of the company and taking reasonable steps for the prevention and detection of fraud and other irregularities.

Company Law Reform

A major inquiry into proposals for modernising company law, starting in the late 1990s,³³ led to a final report in 2001 which made recommendations to government. The government then issued a series of consultation documents leading in March 2005 to a White Paper³⁴ and draft legislation for further consultation. Changes in company law are usually slow, so it takes time for recommended changes to be put into action. Some changes are implemented ahead of others.

At the heart of the Company Law Review was the idea 'think small first'. This reflected a concern that company law has grown by being written for the larger company and then 'slimmed down' for the smaller company. This has tended to leave too great a burden on small companies. Focusing first on the small company should reduce the risk of excessive burden. Disclosure by small companies is described in outline in Chapter 7.

The government indicated that its law reform would also deal with a new EU Directive on audit. Audit is described further in section 4.5.11.

4.5.3 The Financial Reporting Council

The Financial Reporting Council (FRC)³⁵ describes itself as the UK's independent regulator for corporate reporting and governance. It is recognised in its regulatory role by the Department of Trade and Industry. The government effectively delegates responsibility to an independent body but maintains close interest in the strategy and operations of the FRC.

The FRC's aim is to promote confidence in corporate reporting and governance. To achieve this aim it sets itself five key objectives, in promoting:

- high quality corporate reporting
- high quality auditing
- high standards of corporate governance
- the integrity, competence and transparency of the accountancy profession
- its effectiveness as a unified independent regulator.

The FRC is one regulator but it has a wide range of functions:

- setting, monitoring and enforcing accounting and auditing standards
- statutory oversight and regulation of auditors
- operating an independent investigation and discipline scheme for public interest cases
- overseeing the regulatory activities of the professional accountancy bodies
- promoting high standards of corporate governance.

There are five operating bodies (subsidiaries of the FRC) to carry out these functions.

- Accounting Standards Board
- Auditing Practices Board
- Professional Oversight Board For Accountancy
- Financial Reporting Review Panel
- Accountancy Investigation & Discipline Board.

Each one of these is now described.

4.5.4 UK Accounting Standards Board

Traditionally, professions in the UK have been expected to regulate their own affairs and control their members. The accounting profession satisfied this expectation between 1970 and 1990 by forming the Accounting Standards Committee (ASC) and requiring members of each professional body to apply accounting standards or face disciplinary action. Over a period of years there was growing dissatisfaction with this pure self-regulatory model because the disciplinary aspects appeared to be applied only rarely and the existence of potential conflicts of self-interest was pointed to by some critics as weakening the standard-setting process. Consequently, in 1990 the purely self-regulatory approach was abandoned in favour of an independent regime having statutory backing, but retaining some self-regulatory features. The independent standard setting body was created as the Accounting Standards Board (ASB).

Since 1990 the ASB has published Financial Reporting Standards (FRSs) setting standards of practice which go beyond the requirements of company law in particular problem areas. In the period from 1970 to 1990 the standards set by the ASC were called Statements of Standard Accounting Practice (SSAPs). Those SSAPs which remained valid were adopted by the ASB and are gradually being replaced. SSAPs and FRSs collectively are referred to as 'accounting standards'. The Accounting Standards Board (ASB) is recognised as a standard-setting body under the Companies Act 1985.

The UK ASB is gradually harmonising its standards with those of the IASB so that eventually all companies will apply the same accounting standards, irrespective of whether they present financial statements under the IAS Regulation or the Companies Act. Until that happens there will continue to be some differences between ASB standards and IASB standards but in general this need not be of concern in a first year of study.

The ASB collaborates with accounting standard-setters from other countries and the IASB both in order to influence the development of international standards and in order to ensure that its standards are developed with due regard to international developments.

The ASB has up to ten Board members, of whom two (the Chairman and the Technical Director) are full-time, and the remainder, who represent a variety of interests, are part-time. ASB meetings are also attended by three observers. Under the ASB's constitution, votes of seven Board members (six when there are fewer than ten members) are required for any decision to adopt, revise or withdraw an accounting standard. Board members are appointed by a Nominations Committee comprising the chairman and fellow directors of the Financial Reporting Council (FRC).

The Accounting Standards Board is independent in its decisions on issuing standards. Before doing so the Board consults widely on all its proposals.

4.5.5 Auditing Practices Board

The Auditing Practices Board (APB) was established in April 2002, and replaces a previous APB which had been in place since 1991. APB is a part of the Financial Reporting Council. The APB is committed to leading the development of auditing practice in the UK and the Republic of Ireland so as to establish high standards of auditing, meet the developing needs of users of financial information and ensure public confidence in the auditing process.

4.5.6 Professional Oversight Board for Accountancy

The Professional Oversight Board for Accountancy (POBA) contributes to the achievement of the Financial Reporting Council's own fundamental aim of supporting investor, market and public confidence in the financial and governance stewardship of listed and other entities by:

- independent oversight of the regulation of the auditing profession by the recognised supervisory and qualifying bodies;
- monitoring the quality of the auditing function in relation to economically significant entities;
- independent oversight of the regulation of the accountancy profession by the professional accountancy bodies.

4.5.7 Financial Reporting Review Panel

When the Accounting Standards Board was established in 1990 it was felt to be important that there was a mechanism for enforcing accounting standards. An effective mechanism had been lacking in the previous process of setting standards. Accordingly the Financial Reporting Council established a Financial Reporting Review Panel (FRRP) which enquires into annual accounts where it appears that the requirements of the Companies Act, including the requirement that annual accounts shall show a true and fair view, might have been breached. The FRRP has the power to ask companies to revise their accounts where these are found to be defective. If companies do not voluntarily make such a revision, the FRRP may take proceedings in a court of law to require the company to revise its accounts. These powers are contained in the Companies Act 1985 and delegated to the FRRP by the Secretary of State for Trade and Industry. So far the FRRP has not found it necessary to resort to legal action, having found its powers of persuasion were sufficient.

The Financial Reporting Review Panel (FRRP), (referred to as 'the Panel') considers whether the annual accounts of public companies and large private companies comply with the requirements of the Companies Act 1985, including applicable accounting standards. The Panel does not offer advice on the application of accounting standards or the accounting requirements of the Companies Act 1985.

The Panel can ask directors to explain apparent departures from the requirements. If it is not satisfied by the directors' explanations it aims to persuade them to adopt a more appropriate accounting treatment. The directors may then voluntarily withdraw their accounts and replace them with revised accounts that correct the matters in error. Depending on the circumstances, the FRRP may accept another form of remedial action – for example, correction of the comparative figures in the next set of annual financial statements. Failing voluntary correction, the Panel can exercise its powers to secure the necessary revision of the original accounts through a court order. The FRRP

has enjoyed a long and successful record in resolving all cases brought to its attention without having to apply for a court order. The Panel maintains a legal costs fund of £2m for this purpose. Also, if the case concerns accounts issued under listing rules, the Panel may report to the Financial Services Authority.

4.5.8 Accountancy Investigation and Discipline Board

The Accountancy Investigation and Discipline Board (AIDB) is the independent, investigative and disciplinary body for accountants in the UK. It has up to eight members. The AIDB is responsible for operating and administering an independent disciplinary scheme ('the Scheme') covering members of the major professional bodies.

The AIDB will deal with cases which raise or appear to raise important issues affecting the public interest in the UK and which need to be investigated to determine whether or not there has been any misconduct by an accountant or accountancy firm.

4.5.9 Committee on Corporate Governance

The Committee on Corporate Governance works to satisfy the FRC's responsibility for promoting high standards of corporate governance. It aims to do so by:

- maintaining an effective Combined Code on Corporate Governance and promoting its widespread application;
- ensuring that related guidance, such as that on internal control, is current and relevant;
- influencing EU and global corporate governance developments;
- helping to promote boardroom professionalism and diversity; and
- encouraging constructive interaction between company boards and institutional shareholders.

4.5.10 The Financial Services Authority

Under the Financial Services and Markets Act 2000, the Financial Services Authority (FSA) is a single regulator with responsibility across a wide range of financial market activity. It is required to maintain confidence in the UK financial system, to promote public understanding of the financial system, to secure protection for consumers and to reduce the scope for financial crime. The FSA is an independent, non-governmental body and receives no funds from government. It reports annually to Parliament through the Treasury.

The FSA regulates listing of companies' shares on the UK stock exchange. The work is carried out by a division called the UK Listing Authority (UKLA). When a company first has its shares listed, it must produce a prospectus, which is normally much more detailed than the annual report. The regulations covering the content of a prospectus are set by the UKLA. Once a company has achieved a listing, it must keep up with ongoing obligations under the Listing Rules, which includes providing accounting information to the market in the annual report and press releases. Details of the Listing Rules are not necessary for first-year study but if you are interested you can read them on the FSA's website: www.fsa.gov.uk.

4.5.11 Auditors

The shareholders of companies do not have a right of access to the records of the day-to-day running of the business, and so they need someone to act on their behalf to ensure that the directors are presenting a true and fair view of the company's position at a point in time and of the profits generated during a period of time. To achieve this reassurance, the shareholders appoint a firm of auditors to investigate

Exhibit 4.3**Sample audit report****INDEPENDENT AUDITOR'S REPORT TO THE SHAREHOLDERS OF XYZ PLC**

We have audited the group financial statements of (name of entity) for the year ended . . . which comprise the Group Income Statement, the Group Balance Sheet, the Group Cash Flow Statement, the Group Statement of Change in Shareholders' Equity and the related notes. These group financial statements have been prepared under the accounting policies set out therein.

We have reported separately on the parent company financial statements of (name of entity) for the year ended and on the information in the Directors' Remuneration Report that is described as having been audited.

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual Report and the group financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted for use in the European Union are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the group financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). We report to you our opinion as to whether the group financial statements give a true and fair view and whether the group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation. We also report to you if, in our opinion, the Directors' Report is not consistent with the group financial statements, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding director's remuneration and other transactions is not disclosed. We review whether the Corporate Governance Statement reflects the company's compliance with the nine provisions of the 2003 FRC Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the group's corporate governance procedures or its risk and control procedures.

We read other information contained in the Annual Report and consider whether it is consistent with the audited group financial statements. The other information comprises only [the Directors' Report, the Chairman's Statement, the Operating and Financial Review and the Corporate Governance Statement]. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the group financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the group financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the group financial statements, and of whether the accounting policies are appropriate to the group's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the group financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the group financial statements.

Opinion

In our opinion:

the group financial statements give a true and fair view, in accordance with IFRSs as adopted for use in the European Union, of the state of the group's affairs as at . . . and of its profit[loss] for the year then ended; and the group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation.

Registered auditors' Address

Date

the company's financial records and give an opinion on the truth and fairness of the financial information presented. Exhibit 4.3 sets out the wording of a typical audit report to the shareholders of a public company. There are some words and phrases in this report which will become more familiar as you progress through the text. These include 'historical cost convention' (Chapter 14), 'revaluation of certain fixed assets' (Chapter 12) and 'accounting policies' (introduced in Chapter 3 but mentioned again at various points).

You will note that the auditors do not look at all the pages of the annual report. The earlier part of the annual report is important to the companies in setting the scene and explaining their businesses. These earlier pages are reviewed by the auditors to ensure that anything said there is consistent with the information presented in the audited financial statements. You will also note that the auditors have their own code of practice, referred to as International Standards for Auditing (ISAs). The ISAs are prepared by the International Auditing and Assurance Standards Board (IAASB) which operates under a body called the International Financial Accounting Committee (IFAC). The standards are then adopted by national standard setters. In the UK the national standard setter is the Auditing Practices Board (APB) which is one of the arms of the Financial Reporting Council.

What surprises some readers is the phrase 'reasonable assurance that the accounts are free from material misstatement'. The auditors are not expected to be totally certain in their opinion and they are only looking for errors or fraud which is material. The meaning of the word 'material' has proved difficult to define and it tends to be a matter left to the judgement of the auditor. The best guidance available is that an item is material if its misstatement or omission would cause the reader of the annual report (shareholder or creditor) to take a different decision or view based on the financial statements.

4.5.12 The tax system

Businesses pay tax to HM Revenue and Customs (as the tax collecting agent of the government) based on the profits they make. Sole traders and partnerships pay income tax on their profits while companies pay corporation tax. There are differences in detail of the law governing these two types of taxes but broadly they both require as a starting point a calculation of profit using commercial accounting practices. The law governing taxation is quite separate from the law and regulations governing financial reporting, so in principle the preparation of financial statements is not affected by tax matters. That is very different from some other countries in the EU where the tax law stipulates that an item must be in the financial accounting statements if it is to be considered for tax purposes. Those countries have an approach to financial reporting which is more closely driven by taxation matters.

In the UK the distinction may be blurred in practice in the case of sole traders because HM Revenue and Customs is the main user of the financial statements of the sole trader. Similarly, tax factors may influence partnership accounts, although here the fairness of sharing among the partners is also important. The very smallest companies, where the owners also run the business, may in practice have the same attitude to tax matters as does the sole trader or partnership. For larger companies with a wider spread of ownership, the needs of shareholders will take priority.

4.5.13 Is regulation necessary?

There are those who would argue that all this regulatory mechanism is unnecessary. They take the view that in a market-based economy, competitive forces will ensure that those providing information will meet the needs of users. It is argued that investors

will not entrust their funds to a business which provides inadequate information. Banks will not lend money unless they are provided with sufficient information to answer their questions about the likelihood of receiving interest and eventual repayment of the loan. Employee morale may be lowered if a business appears non-communicative regarding its present position and past record of performance. Suppliers may not wish to give credit to a business which appears secretive or has a reputation for producing poor-quality information. Customers may be similarly doubtful.

Against that quite attractive argument for the abolition of all regulations stand some well-documented financial scandals where businesses have failed. Employees have lost their jobs, with little prospect of finding comparable employment elsewhere; suppliers have not been paid and have found themselves in financial difficulties as a result. Customers have lost a source of supply and have been unable to meet the requirements of their own customers until a new source is found. Those who have provided long-term finance for the business, as lenders and investors, have lost their investment. Investigation shows that the signs and warnings had existed for those who were sufficiently experienced to see them, but these signs and warnings did not emerge in the published accounting information for external use.

Such financial scandals may be few in number but the large-scale examples cause widespread misery and lead to calls for action. Governments experience pressure from the electorate and lobby groups; professional bodies and business interest groups decide they ought to be seen to react; and new regulations are developed which ensure that the particular problem cannot recur. All parties are then reasonably satisfied that they have done their best to protect those who need protection against the imbalance of business life, and the new practices are used until the next scandal occurs and the process starts over again.

There is no clear answer to the question 'Is regulation necessary?' Researchers have not found any strong evidence that the forces of supply and demand in the market fail to work and have suggested that the need for regulation must be justified by showing that the benefits exceed the costs. That is quite a difficult challenge but is worth keeping in mind as you explore some of the more intricate aspects of accounting regulation.

Activity 4.4

Look back through this section and, for each subheading, make a note of whether you were previously aware that such regulation existed. In each case, irrespective of your previous state of knowledge, do you now feel a greater or a lesser sense of confidence in accounting information? How strong is your confidence in published accounting information? If not 100%, what further reassurance would you require?

4.6 Reviewing published financial statements

If you look at the annual report of any large listed company you will find that it has two main sections. The first part contains a variety of diagrams and photographs, a statement by the chairman, a report by the chief executive and, in many cases, an Operating and Financial Review which may extend to a considerable number of pages. Other aspects of the business, such as its corporate governance and environmental policy, may also be explained. This first part is a mixture of unregulated and broadly regulated material. There are many sources of influence on its contents, some of which will be explained in later chapters of this book.

The second part contains the financial statements, which are heavily regulated. As if to emphasise this change of status, the second part of the annual report will often have a different appearance, perhaps being printed on a different colour or grade of

paper, or possibly having a smaller print size. Appendix I to this book contains extracts from the financial statements of a fictitious company, Safe and Sure plc, which will be used for illustration in this and subsequent chapters.

Relaxing after a hard workout at the health club, David Wilson took the opportunity to buy Leona a drink and tell her something about Safe and Sure prior to a visit to the company's headquarters to meet the finance director.



DAVID: *This is a major listed company, registered in the UK but operating around the world selling its services in disposal and recycling, cleaning and security. Its name is well known and its services command high prices because of the company's reputation gained over many years. Basically it is a very simple business to understand. It sells services by making contracts with customers and collects cash when the service is performed.*

In preparation for my visit I looked first at the performance of the period. This company promises to deliver growth of at least 20% in revenue and in profit before tax so first of all I checked that the promise had been delivered. Sure enough, at the front of the annual report under 'Highlights of the year' there was a table showing revenue had increased by 22.4% and profit before tax had increased by 20.4%. I knew I would need to look through the profit and loss account in more detail to find out how the increases had come about, but first of all I read the operating review (written by the chief executive) and the financial review (written by the finance director). The chief executive gave more details on which areas had the greatest increase in revenue and operating profit and which areas had been disappointing. That all helps me in making my forecast of profit for next year.

The chief executive made reference to acquisitions during the year, so I knew I would also need to think whether the increase in revenue and profits was due to an improvement in sales and marketing as compared with last year or whether it reflected the inclusion of new business for the first time.

In the financial review, the finance director explained that the business tries to use as little working capital as possible (that means they try to keep down the current assets and match them as far as possible with current liabilities). I guessed I would need to look at the balance sheet to confirm that, so I headed next for the financial statements at the back of the annual report, pausing to glance at the auditors' report to make sure there was nothing highlighted by them as being amiss.

The financial statements are quite detailed and I wanted a broad picture so I noted down the main items from each in a summary format which leaves out some of the detail but which I find quite useful.

4.6.1

Income statement (profit and loss account)

Safe and Sure plc			
Summary income statement (profit and loss account) with comparative figures			
	<i>Notes</i>	Year 7	Year 6
		£m	£m
Continuing operations			
Revenue		714.6	589.3
Cost of sales		(491.0)	(406.3)
Gross profit		223.6	183.0
Expenses and interest		(26.1)	(26.0)
Profit before tax		197.5	157.0
Tax on profit		(62.2)	(52.4)
Profit for the period from continuing operations		135.3	104.6
Discontinued operations			
Loss for the period from discontinued operations		(20.5)	(10.0)
Profit for the period attributable to ordinary shareholders		<u>114.8</u>	<u>94.6</u>



DAVID: It is part of my job to make forecasts of what the next reported profit of the company is likely to be (i.e. the profit of Year 8). This is March Year 8 now so there are plenty of current signs I can pick up, but I also want to think about how far Year 7 will be repeated or improve during Year 8. A few years ago I would have made a rough guess and then phoned the finance director for some guidance on whether I was in the right area. That's no longer allowed because the Financial Services Authority tightened up the rules on companies giving information to some investors which is not available to others, especially where that information could affect the share price.

One easy way out is for me to collect the reports which come in from our stockbrokers. Their analysts have specialist knowledge of the industry and can sometimes work out what is happening in a business faster than some of the management. However, I like to form my own opinion using other sources, such as trade journals, and I read the annual report to give me the background structure for my forecast. The company has helpfully separated out the effect of continuing and discontinued operations, which helps me in making a forecast.

When I meet the finance director next week I'll have with me a spreadsheet analysing revenue and profit before tax – so far as I can find the data – by product line and for each of the countries in which the company trades. I'll also ask the following questions:

- 1 Although the revenue has increased, the ratio of gross profit to revenue on continuing operations has increased only very slightly, from 31.1% in Year 6 to 31.3% in Year 7. That suggests that the company has increased revenue by holding price rises at a level matching the increase in operating costs. I would like to see the company pushing ahead with price rises but does the company expect to see a fall in demand when its prices eventually rise?
- 2 The tax charge on continuing operations has decreased from approximately 33% to 31.5%, slightly higher than the rate which would be expected of UK companies. I know that this company is trading overseas. You say in your financial review that the tax charge is 30% in the UK and rates on overseas profits will reduce, so am I safe in assuming that 30% is a good working guide for the future in respect of this company?
- 3 With all this overseas business there must be an element of foreign exchange risk. You say in your financial review that all material foreign currency transactions are matched back into the currency of the group company undertaking the transaction. You don't hedge the translation of overseas profits back into sterling. You also say that using Year 6 exchange rates the Year 7 profit, including the effect of the discontinued operations, would have been £180.5m rather than the £177.0m reported. That seems a fairly minimal effect but are these amounts hiding any swings in major currencies where large downward movements are offset by correspondingly large upward movements?
- 4 Your increase in revenue, comparing £714.6m to £589.9m, is 21.1% which is meeting the 20% target you set yourself. However, elsewhere in the financial statements I see that the acquisitions in Year 7 contributed £13.5m to revenue. If I strip that amount out of the total revenue I'm left with an increase in respect of activities continuing from Year 6 which is only 19%. When the scope for acquisitions is exhausted, will you be able to sustain the 20% target by organic growth alone?

4.6.2

Balance sheet



DAVID: Looking at the balance sheet, this is a fairly simple type of business. It is financed almost entirely by equity capital (shareholders' funds), so there are none of the risks associated with high levels of borrowings which might be found in other companies.

Again, I have summarised and left out some of the details which aren't significant in financial terms.

Safe and Sure plc
Summarised balance sheet (with comparative amounts)

	Notes	Year 7 £m	Year 6 £m
Non-current assets			
Intangible assets		260.3	237.6
Tangible assets		137.5	121.9
Investments		2.8	2.0
Taxation recoverable		<u>5.9</u>	<u>4.9</u>
		<u>406.5</u>	<u>366.4</u>
Current assets			
Inventories (stocks)		26.6	24.3
Amounts receivable (debtors)		146.9	134.7
Six-month deposits		2.0	–
Cash and cash equivalents		<u>105.3</u>	<u>90.5</u>
		<u>280.8</u>	<u>249.5</u>
Current liabilities			
Amounts payable (creditors)		(159.8)	(157.5)
Bank overdraft		<u>(40.1)</u>	<u>(62.6)</u>
		<u>(199.9)</u>	<u>(220.1)</u>
<i>Net current assets</i>		<u>80.9</u>	<u>29.4</u>
<i>Total assets less current liabilities</i>		<u>487.4</u>	<u>395.8</u>
Non-current liabilities			
Amounts payable (creditors)	9	(2.7)	(2.6)
Bank and other borrowings	10	(0.2)	(0.6)
Provisions	11	<u>(20.2)</u>	<u>(22.2)</u>
<i>Net assets</i>		<u>464.3</u>	<u>370.4</u>
Capital and reserves			
<i>Shareholders' funds</i>		<u>464.3</u>	<u>370.4</u>



DAVID: *By far the largest non-current (fixed) asset is the intangible asset of goodwill arising on acquisition. It reflects the fact that the group has had to pay a price for the future prospects of companies it has acquired. Although the company reports this in the group's balance sheet, and I like to see whether the asset is holding its value from the group's point of view, I have some reservations about the quality of the asset because I know it would vanish overnight if the group found itself in difficulties.*

The other non-current assets are mainly equipment for carrying out the cleaning operations and vehicles in which to transport the equipment. I've checked in the notes to the accounts that vehicles are being depreciated over four to five years and plant and equipment over five to ten years, all of which sounds about right. Also, they haven't changed the depreciation period, or the method of calculation, since last year so the amounts are comparable. Estimated useful lives for depreciation are something I watch closely. There is a great temptation for companies which have underperformed to cut back on the depreciation by deciding the useful life has extended. (Depreciation is explained more fully in Chapter 8.)

I think I might ask a few questions about working capital (the current assets minus the current liabilities of the business). Normally I like to see current assets somewhat greater than current liabilities – a ratio of 1.5 to 1 could be about right – as a cushion to ensure the liabilities are met as they fall due. However, in this company the finance director makes a point of saying that they like to utilise as little working capital as possible, so I'm wondering why it increased from £29.4m in Year 6 to more than £80m in Year 7. There appear to be two effects working together: current assets went up and current liabilities went down. Amounts receivable (trade debtors) increased in Year 7 in absolute terms but that isn't as bad as it looks when allowance is made for the increase in revenue.

Amounts receivable in Year 7 are 20.6% of continuing revenue, which shows some control has been achieved when it is compared with the Year 6 amount at 22.8% of revenue. My questions will be:

- 1 Mostly, the increase in the working capital (net current assets) appears to be due to the decrease in bank borrowing. Was this a voluntary action by the company or did the bank insist?
- 2 The second major cause of the increase in the working capital is the increase in the balance held in the bank account. Is that being held for a planned purpose and, if so, what?
- 3 The ratio of current assets to current liabilities has increased from last year. What target ratio are you aiming for?

I always shudder when I see 'provisions' in a balance sheet. The notes to the financial statements show that these are broadly:

	£m
For treating a contaminated site	12.0
For restructuring part of the business	4.2
For tax payable some way into the future	<u>4.0</u>
Total	<u>20.2</u>

I shall want to ask whether the estimated liability in relation to the contaminated site is adequate in the light of any changes in legislation. I know the auditors will have asked this question in relation to existing legislation but I want to think also about forthcoming legislation.

I am always wary of provisions for restructuring. I shall be asking more about why the restructuring is necessary and when it will take place. I want to know that the provision is sufficient to cover the problem, but not excessive.

The provision for tax payable some way into the future is an aspect of prudence in accounting. I don't pay much attention unless the amount is very large or suddenly changes dramatically. (An explanation of deferred taxation is contained in Chapter 10.)

4.6.3

Cash flow statement



DAVID: Cash is an important factor for any business. It is only one of the resources available but it is the key to survival. I've summarised the totals of the various main sections of the cash flow statement. 'Net cash' means the cash less the bank borrowings.

Safe and Sure plc
Summary cash flow statement (with comparative amounts)
Consolidated cash flow statement for the years ended 31 December

	Notes	Year 7	Year 6
		£m	£m
Net cash from operating activities		143.0	116.3
Net cash used in investing activities		(98.3)	(85.3)
Net cash used in financing activities		(10.2)	(46.4)
Net increase/(decrease) in cash and cash equivalents*		<u>34.5</u>	<u>(15.4)</u>

What I'm basically looking for in the cash flow statement is how well the company is balancing various sources of finance. It generated £143m from operating activities and that was more than sufficient to cover its investing activities in new fixed assets and acquisitions. There was also enough to cover the dividend of £29.5m, which is a financing activity but that was partly covered by raising new loan finance. This is why the cash used in financing activities is only £10.2m. I come back to my earlier question of why they are holding so much cash.

Activity 4.5

Read David's explanation again and compare it carefully with the financial statements. It is quite likely that you will not understand everything immediately because the purpose of this book as a whole is to help you understand published financial statements and we are, as yet, only at the end of Chapter 4. Make a note of the items you don't fully understand and keep that note safe in a file. As you progress through the rest of the book, look back to that note and tick off the points which subsequently become clear. The aim is to have a page full of ticks by the end of the book.

4.7 Summary

The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.

The four principal qualitative characteristics, as described by the IASB *Framework*, are:

- understandability
- relevance
- reliability
- comparability.

Relevance and **reliability** are twin targets which may cause some tension in deciding the most appropriate way to report accounting information.

The accounting measurement principles that are most widely known in the UK are found within the Companies Act 1985:

- going concern
- accruals
- consistency
- prudence.

Prudence in accounting means exercising a degree of caution when reporting assets, liabilities and profits. Overstatement of assets causes the overstatement of profit. Understatement of liabilities causes the overstatement of profit. Prudence requires avoiding overstating profit but also avoiding deliberate understatement of profit.

Regulation of financial reporting in the UK comes from several sources.

- The IAS Regulation requires all listed groups of companies to prepare financial statements using the system of the International Accounting Standards Board (IASB system). Other companies may choose to follow the IASB system.
- Companies that do not follow the IASB system must comply with UK company law.
- The Financial Reporting Council regulates accounting and auditing matters under the authority of UK company law.
- The Financial Reporting Council oversees the UK Accounting Standards Board which sets accounting standards for companies that are complying with UK company law.
- The Financial Reporting Review Panel takes action against companies whose annual reports do not comply with the relevant accounting system (IASB or UK company law).
- The Financial Services Authority regulates a wide range of financial service activities including the London Stock Exchange. It sets Listing Rules for companies listed on the Stock Exchange.
- Auditors give an opinion on whether financial statements present a true and fair view of the profit or loss of the period and the state of affairs at the end of the period. They are professionally qualified accountants with auditing experience who are members of a recognised professional body.

- The UK tax system charges corporation tax on company profits. Her Majesty's Revenue and Customs (HMRC) start with the accounting profit in calculating the amount of tax payable but there are some special rules of accounting for tax purposes.

Further reading

IASB (1989), *Framework for the Preparation and Presentation of Financial Statements*, International Accounting Standards Board.

Paterson, R. (2002), 'Whatever happened to Prudence?', *Accountancy*, January, p. 105.

The website of the Financial Reporting Council explains the methods and nature of regulation of financial reporting and the accountancy profession: www.frc.org.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

- A4.1** Explain what is meant by each of the following: (section 4.2)
- relevance;
 - reliability;
 - faithful representation;
 - neutrality;
 - prudence;
 - completeness;
 - comparability;
 - understandability; and
 - materiality.
- A4.2** Explain the accounting measurement principles of each of the following: (section 4.3)
- going concern;
 - accruals;
 - consistency;
 - the concept of prudence.
- A4.3** Explain why companies should avoid overstatement of assets or understatement of liabilities. (section 4.4)
- A4.4** Explain the responsibilities of directors of a company towards shareholders in relation to the financial statements of a company. (section 4.5.2)
- A4.5** Explain the impact on financial statements of each of the following: (section 4.5)
- company law;
 - the International Accounting Standards Board; and
 - the UK tax law.
- A4.6** Explain how the monitoring of financial statements is carried out by each of the following: (section 4.5)
- the auditors; and
 - the Financial Reporting Review Panel.

B Application

B4.1 [S]

Explain each of the following:

- The IAS Regulation
- The Financial Reporting Council
- The Auditing Practices Board

B4.2 [S]

Explain any two accounting measurement principles, explaining how each affects current accounting practice.

B4.3 [S]

Discuss the extent to which the regulatory bodies explained in this chapter have, or ought to have, a particular concern for the needs of the following groups of users of financial statements:

- shareholders;
- employees;
- customers; and
- suppliers.

C Problem solving and evaluation

C4.1

Choose one or more characteristics from the following box that you could use to discuss the accounting aspects of each of the statements 1 to 5 and explain your ideas:

- relevance
- understandability
- completeness
- reliability
- materiality
- prudence
- comparability
- neutrality
- faithful representation

- Director: 'We do not need to tell shareholders about a loss of £2,000 on damaged stock when our operating profit for the year is £60m.'
- Shareholder: 'I would prefer the balance sheet to tell me the current market value of land is £20m than to tell me that the historical cost is £5m, although I know that market values fluctuate.'
- Analyst: 'If the company changes its stock valuation from average cost to FIFO, I want to hear a good reason and I want to know what last year's profit would have been on the same basis.'
- Regulator: 'If the company reports that it has paid "*commission on overseas sales*", I don't expect to discover later that it really meant bribes to local officials.'
- Director: 'We have made a profit on our drinks sales but a loss on food sales. In the Notes to the Accounts on segmental results I suggest we combine them as "*food and drink*". It will mean the annual report is less detailed for our shareholders but it will keep competitors in the dark for a while.'

C4.2

Choose one or more accounting measurement principles from the following box that you could use to discuss the accounting aspects of each of the problems 1–5 and explain your ideas.

- going concern
- accruals
- consistency
- prudence.

- Director: 'The fixed assets of the business are reported at depreciated historical cost because we expect the company to continue in existence for the foreseeable future. The market value is much higher but that is not relevant because we don't intend to sell them.'
- Auditor: 'We are insisting that the company raises the provision for doubtful debts from 2% to 2.5% of debtor amount. There has been recession among the customer base and the financial statements should reflect that.'

- 3 Analyst: 'I have great problems in tracking the depreciation policy of this company. It owns several airports. Over the past three years the expected useful life of runways has risen from 30 years to 50 years and now it is 100 years. I find it hard to believe that the technology of tarmacadam has improved so much in three years.'
- 4 Auditor: 'We have serious doubts about the ability of this company to renew its bank overdraft at next month's review meeting with the bank. The company ought to put shareholders on warning about the implications for the financial statements.'
- 5 Shareholder: 'I don't understand why the company gives a profit and loss account and a cash flow statement in the annual report. Is there any difference between profit and cash flow?'

Activities for study groups

Continuing to use the annual reports of a company that you obtained for Chapter 1, look for the evidence in each report of the existence of the directors, the auditors and the various regulatory bodies.

In your group, draw up a list of the evidence presented by companies to show that the annual report has been the subject of regulation. Discuss whether the annual report gives sufficient reassurance of its relevance and reliability to the non-expert reader.

Notes and references

1. IASB (1989), *Framework*, para. 12.
2. *Ibid.*, para. 20.
3. *Ibid.*, para. 21.
4. *Ibid.*, para. 24.
5. *Ibid.*, para. 25.
6. *Ibid.*, para. 26.
7. *Ibid.*, paras. 27–8.
8. *Ibid.*, paras. 29–30.
9. *Ibid.*, para. 31.
10. *Ibid.*, paras. 33–4.
11. *Ibid.*, para. 35.
12. *Ibid.*, para. 36.
13. *Ibid.*, para. 37.
14. *Ibid.*, para. 38.
15. *Ibid.*, para. 39.
16. *Ibid.*, para. 42.
17. *Ibid.*, para. 39.
18. *Ibid.*, para. 41.
19. *Ibid.*, para. 40.
20. *Ibid.*, para. 43.
21. *Ibid.*, para. 44.
22. ASB (1999), *Statement of Principles*, p. 34.
23. Companies Act 1985, sch. 4, paras. 10–14.
24. IASB (1989), *Framework*, para. 23.
25. IASB (1989), *Framework*, para. 23.
26. ASB (1999), Appendix III, paras. 21–3.
27. ASB (2000), Financial Reporting Standard 18 (FRS 18) *Accounting Policies*, Accounting Standards Board, para. 28.
28. IASB (1989), *Framework*, para. 37.
29. ASB (2000), Appendix IV, paras. 12 to 20.
30. IASB (1989), *Framework*, para. 27.
31. http://europa.eu.int/comm/internal_market/accounting/index_en.htm
32. www.efrag.org/
33. Details can be found on the website of the Department of Trade and Industry, www.dti.gov.uk/cld/review.htm
34. Company Law Reform, March 2005, Cm. 6456, DTI.
35. www.frc.org.uk/