PART I

The accounting environment

1 Introduction

Aim of this book

Collectively, a board of directors is responsible for the company's annual report and financial statements, yet most directors are not accountants. The primary aim of this book is to explain accounting to those non-executive directors who are not accountants. The book may also be useful to executive directors who are not accountants, and even to directors who are accountants but who have not worked actively in their profession for some time. To some extent this means explaining accounting as one would to any group of intelligent non-accountants. However, we emphasise those aspects that are particularly relevant to the directors of listed companies. For example, in chapter 4 we emphasise the work of the Financial Reporting Review Panel, a body that monitors financial statements and enforces compliance with accounting standards, because while its remit remains public and large private companies, a large focus of its attention is listed companies. Similarly, the specific subjects covered in Part II reflect the likely interest of directors of listed companies: mergers and acquisitions, financial instruments, earnings per share, share-based payment and realised and distributable profits are all discussed. However, the reader will find little on inventory valuation and methods of depreciation, as these are less controversial areas. Similarly, this book does not deal with accounting for special industries and sectors such as banks, insurance companies and charities. As the group financial statements of listed companies must now be prepared using International Financial Reporting Standards (IFRS), rather than UK GAAP, the emphasis in each chapter is on IFRS. How IFRS is applied in the UK, where there are choices, is often influenced by previous UK practice and we discuss this previous UK practice where relevant. In Appendix 1, we set out 50 questions, linked to the chapters, that non-executive directors might find appropriate to ask at meetings of the board or audit committee.

What is accounting?

Accounting is a broad term. It is used to cover the initial recording of transactions in a company's accounting records, although this is better termed 'bookkeeping'. Given the almost universal use of computers for record keeping, even this term is itself only literally accurate either historically, when entries were made in books of account or (originally leather bound) ledgers, or in the smallest of businesses.

The term 'accounting' more properly refers either to the processes that accountants carry out, namely of aggregating and shaping information into reports that are useful to users of those reports; or to the outputs of those processes, namely accounting reports that can be used internally within a business ('management accounting') or externally ('financial accounting' or 'financial reporting'). External reporting can be seen in terms of compliance with legal requirements, for example the requirement under the Companies Act 2006 (CA 2006) to prepare accounts (also called 'financial statements'), circulate them to members, lay them before a general meeting of shareholders (public companies, which includes listed companies, only), and then to file them at Companies House (although small and medium-sized companies can choose to file abbreviated accounts). Other regulatory purposes arise, such as the role of the Financial Services Authority in connection with the supervision of various financial institutions.

Whilst this compliance aspect is important, accounting – both internal and external – is perhaps better seen as a process that serves the decision-making needs of business people and various classes of users of financial statements. Thus, within a company, the board and various other unit and divisional managers need accounting information to enable them to understand and control the business on a regular basis. In most medium-sized and larger businesses, budgets and, subsequently, monthly management accounts are prepared for this purpose. Managers want to know about various financial indicators, such as sales growth, margins, level of costs, amount of funds tied up in inventory (stock) and receivables (debtors) and so on. All of this has the overall objective of seeking to ensure that the company achieves its profit objectives. If the management accounting information shows that budgets are not being achieved, decisions are taken relating to matters such as pricing, level of overheads such as marketing expenditure and staff numbers, or levels of capital expenditure, to try to steer the company back on course to achieving, over the year as a whole, the sales, profit and other measures set out in the budget.

External reporting has an important decision-making focus, as well as a compliance focus. In a narrow, traditional sense, a board of directors presents to shareholders an annual report that gives an account of its stewardship of the company's assets during the year. But even implicit in that is an assumption that the shareholders will consider whether they find the performance to be acceptable. If they do not, that might lead to their refusing to reappoint some directors. So even here there is a notion of decision making.

However, in a modern context, the decision-making role is more explicit. Certainly for companies listed on a stock exchange, the board is reporting to 'the market': the analyst and fund manager community in general and not just to those who happen to be shareholders at present. The market has expectations about earnings, and if the earnings reported disappoint the market, the share price, and sometimes the directors' careers, will suffer. The fundamental decisions taking place here, of course, are concerned with whether to hold, buy or sell the company's shares.

The components of a company's annual report

An annual report, especially of a listed company, is now a very substantial document. The following are currently its main components:

- *Chairman's report*. This is voluntarily given by listed and traded companies and some other public interest entities, but not generally otherwise.
- *Operating and financial review (OFR)*. This is recommended for quoted companies (officially listed in an EEA state or admitted to dealing on either the New York Stock Exchange or NASDAQ) by an Accounting Standards Board (ASB) statement of the same name. It was to have become a statutory requirement for quoted companies, but Gordon Brown, as Chancellor, stepped in at the last minute and announced the withdrawal of the requirements. The original intention was for a statutory OFR to have been required by quoted companies and a similar, but lighter-touch, business review to have been included by all other companies (other than small companies) in their directors' reports. A similar effect has still been achieved; the business review is now required to be included in the directors' report by all companies (other than small companies), but the specified content is greater for quoted companies and, for them, is similar to what would have been required in the statutory OFR.[1]
- *Directors' remuneration report*. Certain disclosures relating to directors' remuneration are required by all companies, but in the case of quoted companies these are more extensive and are presented as a separate report.[2]
- *Report on corporate governance*. This is required for listed companies and, like the OFR and remuneration report, has been a growth area in recent years.[3]
- *Auditors' report*. This is an opinion from the auditor as required by the Companies Act.[4]
- *Directors' report*. This is a legal requirement, although the contents are somewhat arbitrary and not always interesting; hence, historically, the growth of the chairman's statement and OFR as channels of communication. Since 2005, companies (other than small companies) have been required to include a business review within the directors' report. The business review is a narrative report, supplemented with analysis using key performance indicators (KPIs), and is much like an OFR. Indeed, the

1 See ch. 20. 2 See ch. 20. 3 See ch. 20. 4 See ch. 4.

required content for quoted companies was increased with the enactment of the 2006 Act by adding in some of what would otherwise have been included in the statutory OFR had it not been withdrawn at the eleventh hour. Many companies fulfil the requirement for a business review by including an OFR (however named) in the annual report and simply including a cross-reference to it in the directors' report.

- *Performance statements.* Traditionally, the profit and loss account was the principal statement and the way in which a company or group communicated its performance in the year; the 'bottom line' being profit (or loss) for the year. The equivalent statement in IFRS is called the income statement. In the 1990s, the UK GAAP view of performance was extended to incorporate all the other gains and losses made by a company that were reported in the accounts, e.g. gains on revaluing the company's properties, although excluding items arising from transactions with shareholders in their capacity as shareholders, e.g. dividends. Hereafter performance was reported in two statements: the profit and loss account arriving at profit or loss, and the statement of total recognised gains and losses (STRGL), starting with the profit or loss and then listing the other gains and losses. A similar idea was adopted in IFRS. Until 2007, the second performance statement under IFRS could take one of two forms, the more common of which in the UK was the statement of recognised income and expense (SORIE) and this statement was broadly equivalent to the STRGL. Following the 2007 amendment of IAS 1, performance is reported in IFRS accounts either in one statement, the statement of comprehensive income (which combines the income statement and SORIE into one statement), or in two statements, the income statement and the statement of comprehensive income (which in this case would look like the SORIE). See below for a brief explanation and see chapter 9 for a detailed discussion.
- *Balance sheet or statement of financial position*. This sets out the company's assets and liabilities and its shareholders' funds. The balance sheet was traditionally seen as merely a collection of the assets and liabilities that were, so to speak, left over at the end of the year following the matching of costs and revenues in the profit and loss account. More recently, the balance sheet has come to be seen as a more important statement in its own right. For example, stricter definitions of what should be treated as assets and liabilities and the introduction of more fair valuing[5] have increased the importance of the balance sheet.
- *Cash flow statement*. This is, almost literally, a statement of the cash receipts (inflows) and payments (outflows) during the year, categorised under various headings. It may thus correspond more closely to a

5 See ch. 7.

non-accountant's view of performance than profit. See the next section for a comparison of the two.

- *Statement of accounting policies*. Even though much of accounting is specified, there is nonetheless scope in some areas for a company to select accounting policies. In this section of the annual report the company describes the significant accounting policies it has used in preparing its financial statements.
- *Notes to the financial statements*. Many pages of notes are presented in accordance with accounting standards and, for UK GAAP, company law. In general, the notes amplify what is in the income statement, statement of comprehensive income, the balance sheet and the cash flow statement. In addition, there are notes dealing with other matters such as related-party transactions, commitments entered into and key events that occurred after the end of the accounting period. For listed companies, the Listing Rules and Disclosure and Transparency Rules require some disclosures, although these can be outside the financial statements so long as they are within the annual report.

The difference between profit and cash flow

A question frequently asked by non-accountants is what exactly *profit* means and how it differs from *cash flow*. Both are measures of what has happened to a business during a year, but they shed different light on its activities. Cash flow is a natural idea, familiar to us all as individuals. By contrast, profit is an artificial construct. Profit arises from the use of *accruals accounting*, that is, recognising transactions in the period in which they occur, rather than in the period in which the cash is received or paid; it thereby measures the performance of a business. A simple example will illustrate the point.

P Limited:

- Sells goods to customers during 2007 of invoiced value £100. Of this, P receives £50 in cash during the year (the remaining £50 is received in the following year).
- Buys goods from suppliers during 2007 of invoiced value £52. P buys on extended credit and pays nothing in 2007.
- Spends £40 cash on buying office equipment.
- Pays £8 rent for premises to operate from during 2007.

P Limited's cash flow statement will show the figures indicated in Box 1.1.

The company's income statement shows an entirely different picture (see box 1.2).

The two results happen to be quite different in amount (although in other examples they might be similar) and are quite different in principle. The income statement focuses on the transactions that relate to the year in question. So, it focuses on the sales that have been made in the year (£100) and on the cost

Box 1.1 *P Limited*
Cash flow statement for the year ended 31 December 2007

Operating inflows	
Receipts from customers	50
Payment of rent	(8)
Net operating inflow	42
Capital expenditure	(40)
Increase in cash during the year	2

Box 1.2 *P Limited*
Income statement for the year ended 31 December 2007

Revenue (or Sales)	100
Cost of sales	(52)
Depreciation of equipment	(4)
Rental of premises	(8)
Profit before tax*	36

* Tax is ignored in this simple example

Box 1.3 *P Limited*
Balance sheet as at 31 December 2007

Non-current assets (cost £40 less depreciation £4)	36
Receivables (sales made, cash not yet collected)	50
Cash	102
Less: payables (amounts owing to suppliers)	(52)
Net assets	136

of those sales (£52), without reference to whether these amounts have been collected or paid for in cash. Also, the purchase of office equipment is for use in the business over an extended period; it is not held for resale. Hence it is described as capital expenditure and the cost is spread in accounting terms over its useful economic life, in this case assumed to be ten years. The rent is assumed to have been paid in full for the year.

If we assume that P Limited is a new business that started the year by issuing 100 £1 shares at par for cash, we can see that at the end of the year it will have cash of £102 (opening cash of £100 plus increase in cash during the year of £2). However, as shown in Box 1.3, its closing balance sheet will reflect all the assets and liabilities of the business.

Box 1.4 ***P Limited***
Shareholders' equity as at 31 December 2007

Opening shareholders' equity	100
Profit for the year (retained)	36
Closing shareholders' equity	136

These net assets are equivalent to shareholders' equity, as shown in Box 1.4.
This simple example illustrates a number of points. First, it shows that:

Assets *less* liabilities = shareholders' equity

This simple equation demonstrates that shareholders' equity (136 in this example) is the residual interest after all liabilities (52) are deducted from all assets (36 + 50 + 102 = 188).

The second point is that the income statement and the balance sheet articulate with each other. They are both prepared on an accruals basis. Third, the income statement and balance sheet show a much richer set of information than the cash flow statement. This is not to say that the cash flow statement is of little or no value. Indeed, it is important that a business generates cash, otherwise it will run into difficulty; hence cash flow information is useful in its own right. It is also useful as a cross check on the quality of profits.

The example also allows us to view profit in an economic way. Profit can be viewed as the amount that a proprietor can withdraw from a business at the end of a year, such that the business can continue in the following year. We can see from the examples in Boxes 1.2 and 1.4 that the shareholders could have withdrawn the £36 profit and the business would (leaving aside complications such as inflation) have maintained its capital and been able to continue. The £2 increase in cash in the year is not a helpful indicator in these respects.

Of course, merely to speak of 'profit' is an oversimplification. A typical company's income statement may include the figures shown in Box 1.5.

The relatively simple income statement in Box 1.5 uses four variants of the term 'profit'. Whilst they are self-explanatory, it demonstrates the need for clarity in terminology.

Performance statements

In the past, reporting of performance stopped at profit (after tax). However, the notion of performance was extended in the UK in the 1990s. It was recognised that a number of other changes are made to a company's net assets, for example, changes in the value of its assets, and that these should be reflected in the performance statements.

Let us consider further the example of P Limited above. On the first day of 2008, its second year, assume that it issued a further 100 £1 shares at par for cash, took out a bank loan of £100 and used the £200 cash to buy a property

Box 1.5 *Illustrative income statement*

Revenue	100
Cost of sales	(52)
Gross profit	48
Administrative expenses	(23)
Operating profit	25
Interest payable	(7)
Profit before tax	18
Tax	(5)
Profit for the year	13

Box 1.6 *P Limited*
Income statement for the year ended 31 December 2008

Revenue (or Sales)	100
Cost of sales	(52)
Depreciation of equipment	(4)
Depreciation of premises	(4)
Interest payable	(5)
Profit before tax*	35

* Tax is ignored in this simple example

from which to operate. Hence rent is no longer payable. If the interest for 2008 on its loan is £5 and the property is depreciated over 50 years, P's income statement, assuming that sales and cost of sales are as for 2007, will be as in Box 1.6.

Profit is lower than in the previous year. The company now owns its own premises though and on the last day of 2008 these may be valued at £203. If the gain in value of £3 is added to the profit of £35, the 'comprehensive income' made by P Limited in 2008 totals £38, higher than the £36 in the previous year.

An additional performance statement, the statement of total recognised gains and losses (STRGL), was thus introduced into UK GAAP. It started with the profit figure and then listed all other gains and losses, but only if they had been incorporated into the financial statements (rather than simply disclosed in a note). Thus, in the example of P Limited, the gain in value of the business premises would only be included in the STRGL if the property were revalued in the financial statements and the property included in the balance sheet at the end of 2008 at £203. If instead P chose not to revalue its property, the £3 gain would not be included in the STRGL. It is important to note, therefore, that not all changes in value within a business are reported in the performance statements.

When the STRGL was introduced in the UK as a second performance statement, an accompanying rule was introduced, namely that once a gain had been reported in one of the two statements, it could not be reported again (this is called 'recycling' of the gain). Thus, if P Limited sold the property for £203 on the first day of 2009, no gain or loss would be reported on the sale; the gain of £3 having already been reported (assuming that the property was included in the 2008 balance sheet at its value of £203). Although this is the same for some gains in IFRS, for example, for gains in revaluation of properties, it is not so for other gains. For example, when an overseas subsidiary is sold, the cumulative exchange differences that were reported in the second performance statement (e.g. SORIE) are reversed out of the second performance statement and included in the income statement as part of the overall gain or loss on sale of subsidiary. Accordingly, UK GAAP in this respect has been changed to align it with IFRS.

In IFRS prior to the 2007 amendment to IAS 1, the first statement was the income statement, which arrives at profit or loss, and the second statement could be either:

(1) statement of recognised income and expense (SORIE) – this is the statement that most British companies have given. It is equivalent to the STRGL and shows net profit or loss and each of the other changes in net assets (shareholders' equity) other than as a result of transactions with owners in their capacity as owners; or
(2) statement of changes in equity (SOCIE) – this is similar to the SORIE, but additionally has to show transactions with shareholders in their capacity as shareholders and the opening and closing balance of share capital and each reserve.

Why have two performance statements rather than one? Broadly, the original split between the two statements was that value changes, such as gains in property values and actuarial variances on pension liabilities, were included in the second statement, with transactions being recorded in the first statement (income statement or profit and loss account). However, a number of value changes are now included in the income statement in IFRS. These are the value changes that are seen as part of the business's operations. For example, if a business holds investment properties, these are defined as held to earn rentals or for capital appreciation or both and the relevant standard now requires not only the rental income to be included in the income statement, but also the changes in capital value of the property. Similarly, if a business holds investments for trading, the changes in value are required to be recognised in the income statement.

With the 2007 change to IAS 1, performance can now be presented in one statement, a statement of comprehensive income, which combines the income statement and SORIE. Alternatively, companies may continue to present two