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Accounting Principles for Non-Executive Directors

Peter A. Holgate and Elizabeth Buckley

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Accounting Principles for Non-Executive Directors

Good quality non-executive directors are essential to good corporate governance. They bring a wealth of experience to the boardroom, and together with their fellow board members they are responsible for the company's annual report and accounts. However, few are trained accountants.

This volume explains the key elements of a listed company's annual report and accounts. Part I explains the difference between profit and cash flows, the accounting profession, the international harmonisation of accounting rules, the origins of the rules governing the preparation of accounts, the regulation of financial reporting and the overarching principles behind accounting rules. Part II discusses issues relevant to listed companies: mergers and acquisitions; earnings per share; realised and distributable profits; financial instruments; and other key topics. An appendix sets out 50 questions, linked to the chapters, which non-executive directors might like to ask at meetings of the board and audit committee.

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PricewaterhouseCoopers LLP

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Finally, we thank our families, Nelda and Andrew, Chris and Jessica, for their forbearance and we dedicate this book to them.

Peter Holgate
Elizabeth Buckley

London
June 2008

Which standards and legislation has this book been based on?

This book is based on accounting standards (including interpretations) and legislation in issue at 30 June 2008. See appendices 2 and 3 for a full list of such international and UK accounting standards. Not all such standards and legislation were in force at that date, either because they were not yet mandatory or, as was the case with some international accounting standards, they were in issue but had not been adopted by the EU at that date. Where this is the case, the book nevertheless reflects such standards and legislation as they are expected to become mandatory in the UK in due course. Where a standard has been issued that will replace an existing standard, the requirements of the new standard are reflected in the book.

Glossary of terms

Introductory note on terminology

Until 2005 the terminology used in the UK was largely unchanged from that used when accounting standards were originally introduced in the early 1970s. Thus, companies referred to profit and loss accounts and balance sheets, turnover, stock and debtors, to name some of the key terms. The thinking behind what was included in the profit and loss account developed and changed over the years, but the basic statement, the profit and loss account, kept the same name and, in the main, looked much the same. In 1992 a number of changes were introduced which led to the presentation within the profit and loss account changing. At the same time the statement of total recognised gains and losses (STRGL) was introduced along with a different way of viewing performance, until then seen as stopping at the calculation of profit (after tax). This is discussed further in chapter 1 on page 9.

With the adoption of IFRSs in 2005 and the gradual aligning of UK GAAP with IFRS, much of the terminology has changed. Some of the calculations have also changed, but here we are concerned with explaining the different terminology, in particular, where it can be used interchangeably.

Income statement/Profit and loss account – this sets out how the company's profit (after tax) for the period (year, half-year or quarter) has been calculated.

Statement of comprehensive income – this statement was introduced by the 2007 version of IAS 1 and may take one of two forms: (1) where a separate income statement is presented (which is the route we expect most British companies will take) the statement of comprehensive income is an extension of the income statement, like the statement of total recognised gains and losses (STRGL) and the statement of recognised income and expense (SORIE) (see below); and (2) where a separate income statement is not presented, the statement of comprehensive income is the entire statement, the first part being the same as an income statement and the second being like the STRGL or SORIE.

Statement of recognised income and expense/Statement of total recognised gains and losses – these are both extensions of the income statement. The opening line is usually profit/loss after tax, taken from the income statement. Other gains and losses are included, such that the final total in these statements is the total change in net assets other than as a result of transactions with owners in their capacity as owners, e.g. dividends to shareholders.

Statement of financial position/Balance sheet – this is where a company's assets and liabilities are listed.

Revenue/Sales/Turnover – generally this is the first line in the income statement/profit and loss account. It represents the value of goods and services sold by the company during the period. Businesses operating in some industries may use other, more relevant, descriptions, such as rental income or finance income. Whatever the label in the income statement/profit and loss account, this is sometimes colloquially called the 'top line'.

Inventory/Stock – these are the unsold goods or (for a manufacturer) components that are held by the company at any point in time.

Receivables/Debtors – this is the amount of money due to the company from its customers or others at any point in time.

Payables/Creditors – this is the amount of money payable by the company to its suppliers or others at any point in time.

Primary statements – for IFRS, under the 2007 version of IAS 1, these are the balance sheet, income statement (although this can be subsumed within the statement of comprehensive income), statement of comprehensive income, statement of changes in equity and cash flow statement. Under the previous version of IAS 1, these are the balance sheet, income statement, either the statement of recognised income and expense or the statement of changes in equity, and cash flow statement. Under UK GAAP, these are the balance sheet, profit and loss account, statement of total recognised gains and losses and cash flow statement.

Accounts/financial statements – generally these two terms are interchangeable. IAS 1 stipulates that a complete set of financial statements comprises the primary statements together with the notes. The Companies Act does not use the term 'financial statements' and instead refers to accounts. There is a view (which stems from the terminology in the Companies Act) that accounts refers only to the primary statements and does not include the notes, and that financial statements refers to the primary statements together with the notes. However, use of these terms in practice is mixed and either term could be used when referring to the package of primary statements plus notes.

Annual report/Report and accounts – this refers to the total package, including financial statements, that is required to be produced by companies each year – see chapter 1 for a list of what is included.

Glossary of terms

AADB. Accountancy and Actuarial Discipline Board. Part of the FRC.

ACCA. The Association of Chartered Certified Accountants.

Accruals accounting. The method of accounting that underpins the income statement and balance sheet, namely recognising transactions in the period to which they relate, rather than in the period in which the cash is received or paid. Hence: (1) the charge in arriving at profit/loss for an expense is not (except by chance) the same as the amount of cash paid; and (2) the amount recognised as revenue (or turnover or sales) for the year is not (except by chance) the same as the cash received from customers.

Act (or 'the Act'). Unless specified to the contrary, 'Act' or 'the Act' refers to the Companies Act 2006.

AIM. Alternative Investment Market.

Annual report. Financial statements together with the directors' report and, for quoted companies, the directors' remuneration report, and various other information and reports to shareholders – see chapter 1.

APB. The UK Auditing Practices Board. Part of the FRC.

APM. Alternative Performance Measure. Sometimes called adjusted earnings number or non-GAAP measure.

ARC. Accounting Regulatory Committee (of the EU).

ASB. The UK Accounting Standards Board. Part of the FRC.

ASC. The UK Accounting Standards Committee, which set standards from 1970 to 1990, after which the ASB took over the activity.

Asset. In a formal sense, the IASB's Framework for the Preparation and Presentation of Financial Statements defines an asset as: 'a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity'. Less formally, an asset is something of value that a company controls; it is recognised as an asset on the balance sheet if it meets certain recognition criteria, such as whether it can be measured reliably.

Associate. An entity, including an unincorporated entity such as a partnership, over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture (IAS 28, para. 2).

BERR. The department for Business Enterprise & Regulatory Reform. Formerly called the DTI (the Department of Trade & Industry).

Business review. Narrative reporting required to be within the directors' report. It must contain a fair review of the group's business (being, a balanced and comprehensive analysis of the development and performance of the group's business during the financial year and the position at the end of the year, consistent with the size and complexity of the business and containing, where relevant, analysis using KPIs) and a description of principal risks and uncertainties facing the group.

CA 1985. The Companies Act 1985.

CA 2006. The Companies Act 2006.

CCAB. The Consultative Committee of Accountancy Bodies in the UK and Ireland, which comprises:

- The Institute of Chartered Accountants in England and Wales (ICAEW);
- The Institute of Chartered Accountants of Scotland (ICAS);
- The Institute of Chartered Accountants in Ireland (ICAI);
- The Association of Chartered Certified Accountants (ACCA);
- The Chartered Institute of Management Accountants (CIMA); and
- The Chartered Institute of Public Finance and Accountancy (CIPFA).

CESR. The Committee of European Securities Regulators.

CIMA. The Chartered Institute of Management Accountants.

CIPFA. The Chartered Institute of Public Finance and Accountancy.

Combined Code. The UK code of corporate governance, the latest version of which (2008) is published by the Financial Reporting Council.

DB. Defined benefit (pension scheme).

DC. Defined contribution (pension scheme).

Debit/credit. These are bookkeeping terms. A debit entry represents either an expense or an asset (or a reduction of a liability). A credit entry represents either income or a liability (or a reduction of an asset). The application of accounting principles in drawing up financial statements involves determining which debits are to be treated as assets and which are to be treated as expenses; and determining which credits are to be treated as liabilities and which are to be treated as equity or income. As an example, a payment of cash of £100 to acquire inventory (stock) is represented as: Dr Inventory £100 (an increase in the asset 'inventory'); Cr Cash £100 (a decrease in the asset 'cash').

Deferred tax. A way of accounting that, generally, results in the tax consequences of a transaction or event being recognised in the same period and same place (part of profit/loss, other comprehensive income or directly in equity) as the transaction or event itself.

DTR. Disclosure and Transparency Rules issued by the FSA.

Earnings. An undefined term. Generally refers to profit after tax and minority interest. More accurately, it refers to profit after tax, minority interest and preference dividend, this being the definition of earnings used in the calculation of EPS (see below).

EBITDA. Earnings before interest, tax, depreciation and amortisation. This is a measure of earnings favoured by some analysts and companies. Depreciation and amortisation are added back because they are non-cash items. Hence

EBITDA is sometimes called 'cash earnings', although this is something of a misnomer, as it still includes many items calculated on an accruals basis.

EFRAG. The European Financial Reporting Advisory Group, part of the mechanism used by Brussels to help it to consider endorsement of International Financial Reporting Standards for use in the EU.

Entity accounts. The accounts of an entity itself – for example, the accounts of a single company – as opposed to consolidated accounts. Also sometimes called solus accounts. See chapter 8.

EPS. Earnings per share. Broadly, earnings (profit after tax, minority interest and preference dividend) divided by the number of equity shares in issue during the year. The details are set out in IAS 33.

Equity. (1) The IASB's term for share capital and reserves and what is called shareholders' funds in UK GAAP. (2) An equity share, defined in s. 548 of the Act as 'in relation to a company, its issued share capital excluding any part of that capital that, neither as respects dividends nor as respects capital, carries any right to participate beyond a specified amount in a distribution'. Note that accounting standards (international and UK) define equity shares in a different way from the Act.

Equity accounting. This is also known as 'the equity method'. It is the method of accounting adopted for associates and in certain cases for joint ventures, as explained in chapter 8.

ESOP. Employee Share Ownership Plan.

Expense. A reduction in assets, charged in arriving at profit or loss. This includes non-cash items such as depreciation of non-current assets.

FASB. The US Financial Accounting Standards Board.

Financial statements. A company's annual financial statements (or 'accounts'), which comprise the income statement, statement of comprehensive income, the balance sheet, the cash flow statement, the statement of changes in equity and various supplementary notes. They form the major part of the company's annual report; this is sent to shareholders (for quoted companies), made available on a website (for public companies), laid before the company in general meeting and (all companies) placed on the public record at Companies House. Can also refer to other contexts, such as interim financial statements.

FLA. Finance and Leasing Association.

FRC. The UK Financial Reporting Council, the body that oversees the regulation of corporate reporting and audit, including the UK ASB and the FRRP.

FRRP. The UK Financial Reporting Review Panel. Part of the FRC.

FRS. A UK Financial Reporting Standard, an accounting standard developed by the ASB. See also SSAP.

FRSSE. Financial Reporting Standard for Smaller Entities.

FSA. The UK Financial Services Authority.

GAAP. Generally accepted accounting principles, discussed in chapter 1.

Gearing. The relationship between debt and equity. Gearing can be calculated in a number of ways. See chapter 14 for details.

Gross profit. This is profit measured as revenue less cost of sales, that is, profit before deducting overhead expenses, interest and tax.

Half-yearly report. Financial information about the first half of the financial year published by listed companies as required by the FSA as Listing Authority. In the past these have frequently been referred to as the 'interims', although now there is also a requirement for interim management statements (see chapter 6), so it is preferable to use the term 'half-yearly report'.

HMRC. HM Revenue & Customs.

IAS. An international accounting standard issued by the IASC.

IASB. The International Accounting Standards Board, the global standard-setter from 2001.

IASC. The International Accounting Standards Committee, the global standard-setter until 2001.

ICAEW, ICAS, ICAI. See CCAB.

IFRIC. The International Financial Reporting Interpretations Committee, a subsidiary of the IASB.

IFRS. An international financial reporting standard issued by the IASB.

Income. An undefined term, used rather loosely. Can be used as a synonym for profit (e.g. in US parlance 'net income' means profit after tax). Sometimes also, confusingly, used to mean revenue.

Income statement. See above section 'Introductory note on terminology'.

Interest cover. The ratio of interest cost to profit before interest. So if profit before interest is one hundred and interest cost is twenty-five, interest cover is four. That is, interest is covered four times by profits.

Interims. See 'Half-yearly report' above.

Joint venture. A contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control (IAS 31, para. 3).

JV. Joint venture.

KPI. Key performance indicator.

Liability. In a formal sense, the IASB's Framework for the Preparation and Presentation of Financial Statements and IAS 37 'Provisions, Contingent Liabilities and Contingent Assets' defines a liability as 'a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits'. Less formally, a liability is something that a company owes to a third party; it is recognised as a liability on the balance sheet if it meets certain recognition criteria, such as whether it can be measured reliably.

Listed company. A company whose securities are listed on the London Stock Exchange.

Listing Rules. The rules issued by the Financial Services Authority that apply to companies listed on the London Stock Exchange.

LTIP. Long-term incentive plan.

Minority interest. The interest of an outside shareholder in a partially-held subsidiary. Also called 'non-controlling interest'.

NASDAQ. National Association of Securities Dealers Automated Quotation system.

NBV. Net book value. (1) This term applies to non-current (or fixed) assets and refers to the cost or value less accumulated depreciation. (2) It also refers to the carrying value of an asset or liability as it is the amount at which it is stated, or carried, in the balance sheet.

Non-controlling interest. See minority interest.

NRV. Net realisable value.

OFR. The Operating and Financial Review. This was to have become a statutory requirement for quoted companies, but has remained a voluntary report recommended by the ASB. It is a narrative account supplementing the financial statements.

Operating profit. A measure of profit after deducting all operating expenses before deducting interest and tax and, generally, before adding share of results of associates. In UK GAAP, certain exceptional items (non-operating exceptionals or 'super-exceptionals') are also added/deducted after operating profit.

P & L. Profit and loss.

POB. The UK Professional Oversight Board. Part of the FRC.

Prelims. Preliminary announcements of results by listed companies. Previously required by the Listing Rules but now optional, although where produced must adhere to FSA requirements in the Listing Rules.

PPE. Property, plant and equipment.

Profit. A measure of the results of a business on the basis of accruals accounting (see above). (See also gross profit, operating profit, profit before tax, profit after tax.)

Profit after tax. A measure of profit after deducting all expenses, including tax.

Profit before tax. A measure of profit after deducting all expenses apart from tax.

Public company. A company that can offer shares to the public and having an allotted share capital with a nominal value of at least £50,000.

Quoted company. A company whose equity share capital is officially listed in an EEA state or is admitted to dealing on either the New York Stock Exchange or Nasdaq.

Revenue. The amount earned by an entity from selling goods and services. The terms 'sales' and 'turnover' are broadly synonymous with revenue.

Sales. See revenue.

SAS. Statement of Auditing Standards.

SEC. Securities and Exchange Commission.

Shareholders' equity. The aggregate of a company's share capital and its reserves. Called 'shareholders' funds' in UK GAAP.

SIC. Standing Interpretations Committee of the IASC.

SOCIE. See above section 'Introductory note on terminology'.

SoP. Statement of principles.

SORP. Statement of Recommended Practice.

SORIE. See above section 'Introductory note on terminology'.

Sorry. Pronunciation of SORIE (see above section 'Introductory note on terminology').

SPE. Special purpose entity.

SSAP. A UK Statement of Standard Accounting Practice, an accounting standard developed by the ASC. See also FRS.

Statement of comprehensive income. See above section 'Introductory note on terminology'.

STRGL. See above section 'Introductory note on terminology'.

Struggle. Pronunciation of STRGL. See above section 'Introductory note on terminology'.

Subsidiary/subsidiary undertaking. Under IFRS, a subsidiary is 'an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent)'. For UK GAAP and UK law purposes, there is a distinction between 'subsidiary' and 'subsidiary undertaking'. Section 1159(1) of the Act defines a 'subsidiary' for the general purposes of the Act, but not for accounting purposes. Section 1162 of the Act defines a 'subsidiary undertaking' for accounting purposes, chiefly in connection with consolidation.

Summary Financial Statements. A summarised version of the financial statements, directors' report and directors' remuneration report that can be sent to members in place of the full annual report – see chapter 6.

Turnover. See revenue.

UITF. The UK Urgent Issues Task Force. This is a subsidiary of the ASB.

XBRL. Extensible Business Reporting Language.

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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 'book-keeping'. 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.