Financial Reporting Council

THE STATE OF FINANCIAL REPORTING

Third Annual Review

November 1993

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Introduction

This year's survey of financial reporting - the third issued by the Financial Reporting Council - adopts a new pattern. The survey begins with an overview by the Chairman (pages 2 to 4). Then after a brief review of the past year (to October 1993) (pages 5 to 10) the survey takes a more detailed look at the year ahead (pages 11 to 17). There then follows a chapter on audit (pages 18 to 20). Finally, the survey takes stock in the light of the three years that the Council and the Accounting Standards Board, and the two years that the Financial Reporting Review Panel, have been in operation (pages 21 to 25).

The material relating to the Accounting Standards Board and the Financial Reporting Review Panel has been provided by their respective Chairmen, David Tweedie and Edwin Glasgow. The Financial Reporting Council has no responsibility for audit, but good financial reporting is bound up with effective audit, and it is therefore appropriate to note progress in this area. The chapter on audit has been provided by Bill Morrison CBE, Chairman of the Auditing Practices Board and a member of the Financial Reporting Council.

Our aim has been to keep this survey short and readable. More detailed information about the composition and activities of the Financial Reporting Council, the Accounting Standards Board and the Financial Reporting Review Panel, including details of their publications, is available from:

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Overview by the Chairman of the Financial Reporting Council

1.1 The last year has seen the FRC and its operational bodies fully into their stride, as the following sections of this survey will show.

1.2 The moves that have been taking place in the development of new accounting standards, in giving authoritative interpretations of existing standards, and in enquiring into departures from standards and other requirements through the Review Panel, have now been paralleled by action in audit and in the wider aspects of corporate governance. The last year has therefore been one of strong and major development across the whole field of financial reporting.

1.3 I welcome these necessary initiatives to put financial reporting and related aspects of corporate governance on a footing that will maintain confidence in financial accountability in this country. They come at a time when confidence had taken some serious knocks through a series of corporate disasters. These have pointed up the need to serve shareholders, creditors, and employees better.

1.4 I have no reservations about these initiatives, for which within the Financial Reporting Council's area of responsibility there is wide support for the broad thrust of the action being taken. There has nevertheless been concern that the totality of the various initiatives that have been put in hand across the whole field of the financial aspects of corporate governance, could, unless their timing is correlated sensitively, result in new proposals bunching in a way that makes it difficult for the preparers of accounts (as well as the users) to offer comment, and then to implement the changes, in an orderly way.

1.5 This understandable concern has been recognised by those who have the responsibility for formulating new proposals; and in the summer the various parties came together under my chairmanship and agreed on the need to correlate their initiatives so that without impacting materially on the overall pace of change they could be phased more evenly. Those concerned have agreed to meet at three-monthly intervals to that end while this period of particular change continues, and I am sure that we shall continue to tackle the issues sensitively.

1.6 Speaking in a personal capacity, I have given expression to some concerns about audit. Those concerns derive from the shared interest we all have in the continued provision of effective audit at reasonable cost. In my view this could be put at risk if

practice in the United States of America extends to this country, with heavy suits for damages against the auditor becoming a possibility whenever there is company failure. I have no time for bad auditing; there should be penalties for it, both professional and financial. But there is a risk of the financial penalties getting out of hand. Already it is no longer possible for audit practices to get full insurance cover from the insurance market, and this carries with it the danger that to protect themselves auditors will be obliged either to accept as audit clients only those whose audits can be undertaken with minimal risk or to increase substantially the scope of their audit, with a corresponding increase of the cost to industry.

1.7 For similar reasons it is important that the auditor should not be drawn into the audit of, or provision of a professional opinion on, matters that lie on the edge of his professional competence. Apart from the issue of costs, such a development could all too easily open the door to misjudgements that damage the reputation of the auditor and audit as well as giving rise to the kind of claims that are causing current difficulties.

1.8 The Financial Reporting Council rightly takes an interest not only in accounts but also in the whole content of companies' annual reports. This wider perspective is important, especially for lay readers, who will often find much difficulty in interpreting the information given in the accounts and in the notes to them.

1.9 The Council therefore gave its strong support to an initiative by the Accounting Standards Board to develop an Operating and Financial Review (OFR) drawing on best practice, to guide companies on the information that should be provided to readers of the annual report. The Council, in giving its support, welcomed the Accounting Standards Board's approach of leaving it to companies to decide how the information is to be provided - whether in a self-contained section or in the course of the various sections of the report. It was pleasing that the ASB's initiative also attracted the support of the London Stock Exchange and the Hundred Group of Finance Directors.

1.10 One of the principal tasks of the Council is to raise the funding required for the work of the bodies under its aegis. I am glad to report both that these bodies have invariably worked within their budgets, and that the funds have been forthcoming from our supporters to ensure that their work can proceed. The work of the Accounting Standards Board, the Financial Reporting Review Panel (as regards its operational expenses) and the Urgent Issues Task Force, and of the Council itself, has been within a sum of around £2 million a year for the first three years of their

operation. From my discussions with the various sources of funding I am clear that, although funding will never be an easy matter, and expenditure will always need to be under close scrutiny, there should be a sufficiency of funding to enable the work to continue in the years ahead. For the Review Panel, the target we set ourselves, to establish a legal costs fund of £2 million, has been achieved. Only small replenishments have been required to offset drawings upon it.

1.11 In summary, the work proposed in the 1988 report on "The Making of Accounting Standards" is now fully under way; the three bodies established to undertake the work have achieved high credibility; good progress is being made; and support for them is reflected in our ability to secure a continuance of funding in difficult economic circumstances.

1.12 More significant, financial reporting is now an issue that concerns the boards of companies as a whole rather than being seen as the specified responsibility of the finance director: it is now on the agenda. In raising the profile of financial reporting the Council and the bodies it has created recognise that they need to be sensitive about the phasing of change. But change is never easy, and in offering my last introduction to a Council Review I would observe that while the work of the Accounting Standards Board and the Review Panel will always be challenging to the preparers of accounts, their concern - the justification for their very existence - is to serve industry and commerce through facilitating the effective working of a market economy. I believe the work they have done in the three years since the Council came into being has served precisely that purpose.

R E DEARING

Review of the year to October 1993

Financial Reporting Council (FRC)

2.1 The Council met twice during the year. A central element at each meeting was a progress report and outline of forward plans from the Chairman of the Accounting Standards Board and a progress report from the Chairman of the Financial Reporting Review Panel.

2.2 Another major feature was the consideration and general endorsement of the report of the Committee on the Financial Aspects of Corporate Governance (the Cadbury Committee) on which four members of Council had served.

2.3 The Council also endorsed, and contributed an introductory preface to, the Accounting Standards Board's statement on Operating and Financial Review.

2.4 As is mentioned in his introduction, the Chairman of the Council convened an informal group to discuss the problems of possible 'overload' in the issue of new financial reporting proposals by various bodies, and the group has met twice during the year. Those involved in this work are the Hundred Group of Finance Directors, the Institute of Chartered Accountants in England and Wales, the Auditing Practices Board, the Accounting Standards Board and the Cadbury Committee. The bodies concerned have made good progress towards ensuring that documents they issue are published in an orderly way. They will continue to meet as necessary.

Accounting Standards Board (ASB)

2.5 During the year the ASB published the following:

Financial Reporting Exposure Drafts (FREDs)

FRED 3	Accounting for Capital Instruments
FRED 4	Reporting the Substance of Transactions
FRED 5	Amendment to FRS 3 in respect of Insurance Companies
FRED 6	Accounting for Acquisitions and Mergers

Discussion Papers

The Role of Valuation in Financial Reporting
Fair Values in Acquisition Accounting

Discussion Drafts (draft chapters of the ASB's Statement of Principles)

Chapter 5 - Measurement in Financial Statements

Other documents

Foreword to Accounting Standards
Statement on Operating and Financial Review
Amendment to SSAP 15 (Accounting for deferred tax)
Amendment to FRS 3 - Insurance companies

2.6 The Foreword to Accounting Standards contains an Opinion by Miss Mary Arden QC (now the Hon. Mrs Justice Arden) on the relationship between the true and fair requirement in the Companies Act 1985 and accounting standards. The Opinion is concerned with the effect of recent changes in the law on the relationship between accounting standards and the requirement in sections 226 and 227 of the Companies Act 1985 (as amended) that accounts drawn up in accordance with the Companies Act 1985 give a true and fair view of the state of affairs of the company, and where applicable the group, at the end of the financial year in question and of the profit and loss of the company or group for that financial year. It expresses the view that changes brought about by the Companies Act 1989 and changes in the standard-setting process have enhanced the status of accounting standards in legal proceedings.

2.7 Work continued during the year on a number of other projects. More details of these, and of the future development of the items listed above, are given in section 3.

Urgent Issues Task Force (UITF)

2.8 During the year the UITF issued the following Abstracts:

Abstract 6 - Accounting for post-retirement benefits other than pensions
Abstract 7 - True and fair view override disclosures
Abstract 8 - Repurchase of own debt
Abstract 9 - Accounting for operations in hyper-inflationary economies

2.9 A number of other subjects were considered where the UITF concluded that the matter should not be pursued.

2.10 The ASB also published for comment its draft Foreword to UITF Abstracts.

2.11 Information Sheets were published giving details of the items on the UITF's agenda. This circulation includes the finance directors of all listed companies.

Public Sector Liaison Committee (PSLC)

2.12 The PSLC continued to assist in the process of applying the ASB's principles and approach to public sector interests wherever applicable. A major task was contributing to the consideration of a Statement of Recommended Practice (SORP) on the Code of Practice on Local Authority Accounting in Great Britain.

Statements of Recommended Practice (SORPs)

2.13 The ASB continued its policy of giving a "negative assurance statement" to SORPs where it was satisfied that they had been developed by a body sufficiently representative of the sector in question and where the ASB's code of practice for the development of SORPs had been followed. In addition to the Local Authority SORP mentioned above, proposals at varying stages were considered.

2.14 A number of proposals were considered during the year from universities, housing associations and the Charity Commission, putting pressure on the ASB's resources. The ASB's future approach towards SORPs is outlined in Section 3, paragraphs 3.25 and 3.26.

The Republic of Ireland

2.15 Close contact was maintained during the year with the Institute of Chartered Accountants in Ireland, which is responsible for promulgating accounting standards in the Republic. A representative of the Republic's Department of Enterprise and Employment continued to attend meetings of the Financial Reporting Council as an informal Observer.

International Developments

2.16 The ASB continued to liaise closely with the UK representatives on the International Accounting Standards Committee (IASC) to ensure that they were fully informed of the Board's policy and plans. Good contact was also maintained with the IASC Secretariat.

2.17 Much interest has been generated in recent years by the possibility that the International Organisation of Securities Commissions (IOSCO) might encourage its member bodies to accept financial statements drawn up in accordance with, or reconciled to, IASC standards as the basis for filings by foreign registrants. At a conference in London in June to celebrate the 20th Anniversary of IASC, M. Saint Geours, President of the French Commission des Operations de Bourse and Chairman of the Technical Committee of IOSCO, said that the time seemed ripe for IOSCO to consider giving its approval for this purpose to a revised set of International Accounting Standards, which IASC was due to finalise later in the year. In November the IASC Board gave final approval to the package of revised standards and will now be looking to IOSCO to recommend their acceptance to its member bodies.

2.18 The ASB was represented at the EC Accounting Advisory Forum, which met in October. At the meeting the Commission clarified the role of the Forum as being purely the provision of advice to the Commission. Votes are not taken and views expressed do not bind either the standard-setting bodies represented or the Commission itself. Documents developed by the Forum are to be considered by the Contact Committee, the formal committee of officials from Member States established under the accounting Directives to monitor their implementation. The Contact Committee may add its own reactions and the documents would then be published with a statement emphasising their consultative nature. A clear distinction is thus preserved between the advisory role of the Forum and any initiatives from the Commission for changing Directives or issuing non-mandatory Recommendations. All such initiatives would follow the prescribed procedures which allow ample opportunity for all interested parties to contribute.

2.19 Three papers developed by the Forum have now been passed to the Contact Committee with a view to publication: Government Grants; Foreign Currency Translation; and Leasing. The Forum is currently studying environmental accounting and disclosure issues; cash flow statements; and the conflict between interpretations of the prudence and matching principles.

2.20 During the year the ASB had bilateral contacts with Australia, Canada, France, New Zealand, South Africa, Sweden and the United States of America. An informal meeting was also held with senior finance executives, auditors and academics concerned with accounting developments in Germany.

2.21 In early November the ASB hosted a meeting of national standard-setting bodies held in London under the auspices of IASC. The meeting was attended by representatives from eighteen countries as well as the IASC, the EC Commission and the European Federation of Accountants. Similar meetings had been held in other countries in each of the previous two years. The London meeting was the most formal to date, discussing papers on three technical subjects - 'Accounting for Future Events', 'Leases' and 'Goodwill' - as well as receiving a report on the IASC Financial Instruments project. The object of the meeting was not to develop international standards but to share experiences and identify themes that could usefully be developed in the standards programmes of a number of countries. One such, of particular relevance to the ASB, was the circumstances in which provision should be made for costs anticipating future events. The ASB collaborated with the IASC and the standard-setters of Australia, Canada and the United States of America on this project and was pleased to find in this group as well as among participants from a number of other countries a significant degree of agreement on how standards should develop in this area. The two days of discussions brought evidence of many common problems and indicated an encouraging willingness by standard-setters from all countries represented to co-operate, to the extent of the discretion available to them, in finding common solutions.

The Financial Reporting Review Panel (FRRP)

2.22 The FRC's second annual survey reported on the Panel's activities up to late November 1992. Since that time, and up to the date that this survey went to press (mid-November 1993), the accounts of some 45 companies had been drawn to the Panel's attention. The references were, as in the past, from three broad sources - qualified audit reports or disclosed non-compliance with accounting standards or other requirements (5), cases referred by individuals or corporate bodies (22), and press comment (18).

2.23 Of these cases, together with the 19 cases outstanding at the publication of the previous survey, 11 were not pursued beyond an initial examination, either because they did not fall within the ambit of the legislation or because no point of substance arose. After further consideration by the Panel and, where appropriate, discussion with the companies concerned, action was concluded on 42 of the remaining 53 cases. At the time of writing this report 11 were still under consideration. Public statements were issued in respect of 9 of the concluded cases.

2.24 As in past years it has not been necessary for the Panel to seek recourse to the court; all the cases mentioned above were concluded by voluntary agreement with the directors of the companies concerned.

2.25 A significant development during the year was the issue by the Panel in September 1993 of a revised version of its Procedures. The version, which was developed in consultation with the Department of Trade and Industry, is intended to simplify and streamline the Panel's approach and to enable it to deal with cases more speedily. There is greater provision for cases to be handled informally in the early stages, including greater scope for preliminary and informal meetings with Panel officials and members. The revised Procedures also enable the Panel, subject to considerations of confidentiality, to give professional bodies greater information to assist such bodies in carrying out their regulatory and supervisory responsibilities.

2.26 When it published its revised Procedures the Panel also announced that it aims in future in its public statements to specify more precisely the section of the Companies Act 1985 or the accounting standard at issue.

The year ahead

Financial Reporting Council (FRC)

3.1 The year ahead will see the Council continuing the general roles adopted from its inception. These are

- to promote good financial reporting, and in that context from time to time to make public its views on reporting standards, making representations to government on the workings of current legislation when appropriate;
- to provide guidance to the Accounting Standards Board on work programmes and on broad policy issues;
- to verify that the arrangements under the umbrella of the FRC are conducted with efficiency and economy and that they are adequately funded.

3.2 A particular task that will need to be continued in the year ahead, in the interests of good financial reporting, is the informal co-ordination of the bodies referred to in paragraph 2.4 with the aim of ensuring that unnecessary problems of 'overload' do not arise. All the parties concerned are ready and anxious to co-operate, and the problem is not one of co-operation but rather one of reconciling conflicting considerations.

3.3 On the one hand there is the need to give all concerned - preparers, auditors and, not least, users of accounts - adequate time to respond to the various initiatives. On the other there is the pressing need to remove uncertainties and provide clear guidance on the issues in question. There is general agreement that the process of improvement of accounting and auditing standards must continue, and that the full measure of the Cadbury conclusions can be achieved only when the detailed guidance that the report called for has been provided. Through its Chairman the FRC will continue to play its part in helping to achieve the right balance between these various considerations.

Accounting Standards Board

3.4 The year ahead will be a challenging one for the ASB, during which it will be tackling and taking forward some particularly difficult and controversial issues. As foreseen at present the pattern is likely to be as follows:

3.5 *A Financial Reporting Standard (FRS) on Capital Instruments* is due to be issued around the time that this survey appears. The FRS will largely reflect the Financial

Reporting Exposure Draft (FRED 3) on this subject, and aims to secure clear and appropriate distinctions in the balance sheet between various kinds of capital instruments and to ensure that their respective costs are properly reflected in the accounts.

3.6 This will be followed in early March 1994 by an *FRS on Reporting the Substance of Transactions.* (The issue of this FRS has been deferred to assist in avoiding 'overload'.) This FRS will reflect the general thrust of FRED 4, taking into account comments received and subsequent consultation with specialist bodies on certain aspects. The essential thrust of the FRS is to ensure that financial statements report the substance of transactions and not merely their legal form. The FRS will be of particular relevance to off balance sheet finance transactions.

3.7 The other FRS likely to be issued during 1994 is that on *Accounting for Acquisitions and Mergers,* following on FRED 6, which was issued earlier in the year and the comments on which are now being reviewed by the ASB. One of the key aims of the ASB's proposals in the FRED was to keep pace with developments in the relevant international standards by providing a much clearer definition of the circumstances in which acquisition accounting should be adopted and those in which merger accounting is applicable.

3.8 As part of its policy of reviewing its standards the ASB will be considering during the year *whether any revision should be made to* its first accounting standard - *FRS 1: Cash Flow Statements* - in the light of the experience of two years' operation. A request for comments will be issued by the Board in early 1994. The intention is to elicit proposals for improvement and if thought necessary to publish an exposure draft of any suggested amendments to the standard.

3.9 Two FREDs are foreshadowed for the year ahead; it is possible, though less certain, that there will be others. The more controversial of the two is a *FRED on Fair Values in Acquisition Accounting,* on which a Discussion Paper was issued in April 1993. The responses to the Discussion Paper have indicated strongly divided views on the subject, though there appears to be widespread support for action, broadly in line with the ASB's earlier proposals, to deal with some unsatisfactory features of present practice.

3.10 Some of those who responded have expressed the view, which the ASB shares, that the proposals need to be considered in the context of the ASB's proposals on accounting for goodwill. It is therefore the ASB's intention to issue the FRED on Fair

Values and a Discussion Paper on Goodwill (see below) at about the same time.

3.11 The second *FRED* foreseen is that on *Related Party Transactions,* the problems of which have featured in a number of company failures. The ASB's proposals will take forward those developed by our predecessor body, the Accounting Standards Committee (ASC), in its Exposure Draft ED 46. A major area of controversy in ED 46 was the division of transactions for related parties into those that were normal and those that were abnormal. Only the abnormal were to be disclosed. Concern was expressed by many of those responding to ED 46 that it was extremely difficult to identify abnormal transactions and consequently the proposed FRED is likely to adopt the international position of requiring the disclosure of all material transactions with related parties. There is obviously a danger of information overload and the FRED will attempt to strike a balance between adequate disclosure and indigestible detail.

3.12 Probably the most difficult and controversial of the topics to be tackled by the ASB in the year ahead will be *Accounting for Goodwill,* including accounting for intangible assets, on which it is intended to publish a *Discussion Paper* in the near future. From the comments received on ED 47 issued by the ASC and from the ASB's own contacts with users, preparers and auditors it is clear that opinions are sharply divided and strongly held. There are broadly three schools of thought, and the pros and cons of each will be considered in the ASB's Discussion Paper.
Some favour the writing off of goodwill against reserves on the grounds that neither internally generated nor purchased goodwill should be shown in financial statements; some prefer amortisation against profits over a fixed period on the grounds that purchased goodwill declines and is replaced by internally generated goodwill, which is not shown in financial statements; and some support the retention of goodwill on the balance sheet provided that its value can be sustained in a systematic way, on the grounds that goodwill merely represents that part of the underlying investment not represented by assets and liabilities and, broadly, should be written down only when the value of that investment declines. The ASB has been carrying out a good deal of exploratory work on this last aspect, including field testing possible approaches with a number of companies.

3.13 The ASB will be hoping for a thorough and constructive response to its proposals to enable it to move to a FRED that, while it cannot meet all points of view, will nevertheless command acceptance.

3.14 Three other Discussion Papers are foreseen in the year ahead, each on an area of accounting that has its own difficulties and complications.

3.15 *A Discussion Paper on Associates and Joint Ventures* will seek to move consideration of this area forward to the stage where proposals can be developed for inclusion in a later FRED. The ASB has been concerned that in the past some investments may have been accounted for as associated companies when there has been little influence exerted by the investing company. The ASB is therefore exploring the notion that an associated company should be more of a quasi-partnership through which the investing company conducts part of its business. This would mean that the nature of associated companies would become closer to that of a joint venture. Consequently the ASB is considering whether the equity accounting method might be used for both associated companies and joint ventures.

3.16 The Discussion Paper is expected to be accompanied by a *Discussion Draft of Chapter 7 of the ASB's Statement of Principles* on the subject of the reporting entity, which would define the types of companies to be included in group accounts.

3.17 *A Discussion Paper on Pension Costs in Company Accounts* will consider whether revision of SSAP 24 would be desirable, given the practical experience now gained of its operation and wider issues currently under discussion following the Goode Report. Accounting practice overseas has tended, however, to move in a different direction from that in the United Kingdom and the ASB believes that in the interests of international harmonisation it should explore the overseas developments and ultimately expose them for comment as alternatives to the method based on SSAP 24 to obtain views about the future direction of accounting for pension costs in the United Kingdom. It should be stressed that by exploring overseas practices the ASB is not committing itself to their adoption.

3.18 Similarly a *Discussion Paper on Accounting for Deferred Tax* will consider the need for revision of SSAP 15 in the light of experience and legislative change since SSAP 15 was prepared and revised.

3.19 The ASB has already amended SSAP 15, as it was realised that the standard was inconsistent with SSAP 24. The review of SSAP 15 will be conducted in parallel with that of SSAP 24. Most countries account for deferred tax on a full provision basis. The UK is almost alone in adopting a partial provision basis, though its relatively generous fiscal regime appeared to justify a special treatment in the past. A Discussion Paper will consider the various major options for accounting for deferred tax with a view to ascertaining whether a complete change is required from present accounting practices or whether SSAP 15 could continue to serve if amended in certain aspects.

3.20 One important project on which the ASB may make a further pronouncement in the year ahead, though this is not certain, is that on *the role of valuation in financial reporting* and the accompanying issue of *measurement in financial statements* on which the ASB published a Discussion Paper and Discussion Draft respectively earlier in the year.

3.21 Responses to the Discussion Paper on the role of valuation in financial reporting indicated that some form of modified historical cost system would be preferable and supported the ASB's view that if the system were to be adopted then regular revaluations of certain assets should be made. The ASB will, in due course, consider these responses in detail and bring forward a further Discussion Paper for consideration.

3.22 Some have seen the existing Discussion Paper and other ASB work as indicating a desire by the ASB to focus on the balance sheet at the expense of the profit and loss account or even as a covert move towards a system of current cost accounting. The ASB has no such intentions, as various passages in its existing publications clearly show.

3.23 It is hoped that the year ahead will also see the publication of an *Exposure Draft collecting together all seven draft chapters of the ASB's Statement of Principles* (of which six have been published to date), so that they can be considered and commented on as an entity before being published as an ASB Statement. Such a statement would not have mandatory status.

3.24 If time permits the ASB will also consider the work done on its behalf by the Institute of Chartered Accountants in England and Wales on *Interim Financial Reporting* by examining the responses to the Institute's proposal and determining the shape of a future exposure draft on the subject.

3.25 One general issue that the ASB plans to tackle in the year ahead is its policy for the consideration of proposed *Statements of Recommended Practice (SORPs)*. The ASB's examination of SORP proposals, even on the basis of a 'negative assurance statement', has proved very time-consuming of its limited resources, and a better way needs to be found that preserves the ASB's involvement, so as to ensure that SORPs are properly developed and that their accounting principles are consonant with those of the ASB, while reducing the detailed demands on its members and staff.

3.26 Consideration is being given to the establishment of advisory sub-groups to assist the ASB in reviewing proposals from SORP-making bodies. Each group would be chaired by a Board member and would include not only experts familiar with the sector concerned but also a sufficient number of generalists to ensure that attention was given to the need to dovetail as smoothly as possible the special requirements of the SORP with the overriding requirements of accounting standards. If this plan is pursued, one or more sub-groups are likely to be required for the financial sector and one for not-for-profit organisations. Discussions are also being held with the relevant government departments to consider analogous arrangements for an ASB review procedure for accounting codes of practice applicable to public sector bodies and other organisations whose accounting requirements are set by governmental regulations.

Urgent Issues Task Force (UITF)

3.27 Early in the year ahead will be the publication of the *ASB's Foreword to UITF Abstracts* which will set out the status of Abstracts and the process by which they are formulated. An annex will give an updated version of the constitution, membership and working methods of the UITF.

3.28 The next twelve months will see the UITF continuing and developing its role of assisting the ASB in areas where an accounting standard or Companies Act provision exists but where unsatisfactory or conflicting interpretations have developed or seem likely to develop. As discussed in section 5 (paragraphs 5.13 and 5.14), the ASB hopes that increasingly preparers and auditors will bring substantive new issues that could create precedents for others to the UITF before positions have been taken.

International Developments

3.29 In the year ahead the ASB will continue to liaise closely with those concerned with the setting of International Accounting Standards, with its counterparts in other countries, and with the EC Commission.

3.30 As described in section 2, the ASB has been steadily increasing its contacts with the IASC and with standard-setters overseas in an attempt to improve harmonisation of accounting standards internationally.

3.31 In its own projects, the ASB's policy is to examine at the outset the corresponding international pronouncements to ascertain whether they could be adopted in the United Kingdom. The general rule is to follow such pronouncements except when they cannot be implemented because of UK law or where they appear to be outdated or unsuitable for the UK financial environment.

3.32 Given its limited resources the ASB has proposed to certain standard-setters overseas that it might be helpful to combine in producing standards dealing with common problems. An example is the collaboration with other standard-setters on the circumstances when provisions can be recognised, which has been described in paragraph 2.21.

3.33 Over the year ahead the ASB intends to carry forward these policies and initiatives and to play its full part in fostering harmonisation of accounting standards, both within Europe and internationally.

Financial Reporting Review Panel

3.34 The Panel will continue to examine accounts of companies drawn to its attention within the framework and authorisation set by the Department of Trade and Industry. Its hope is that its revised Procedures, published at the end of September 1993, will enable it to deal with cases more efficiently, both from its standpoint and that of the companies in question.

Audit

(Chapter contributed by the Chairman of the Auditing Practices Board).

4.1 The Auditing Practices Board (APB), whilst independent of the FRC, is undertaking a challenging programme of work, many aspects of which are directly relevant to the wider consideration of good financial reporting and the promotion of higher standards of corporate governance.

Auditors' reports on financial statements

4.2 In May 1993 the APB reached a significant milestone with the publication of its first Statement of Auditing Standards: SAS 600 'Auditors' reports on financial statements'. This introduced a new expanded form of auditors' report, including a brief description of the respective responsibilities of both directors and auditors, and summarising the principal stages of an audit. The APB believes that these changes will assist readers to understand the basis and significance of the auditors' opinion, whether qualified or unqualified.

4.3 Another important feature of SAS 600 concerns qualifications of the auditors' opinion. Formerly, auditors were required to qualify the opinion whenever there was an inherent uncertainty that had a material impact on the financial statements (a 'subject to' qualification). In future, provided the auditors are satisfied with the accounting treatment adopted by the directors and with the nature and extent of any necessary disclosures, auditors will give an unqualified opinion. This change places greater emphasis on the need for the auditors to be fully satisfied with the adequacy of the accounting treatment and disclosures.

Revisions project

4.4 The APB has initiated a major project to revise all of the Auditing Standards and Guidelines that had been developed by its predecessor (the Auditing Practices Committee).

4.5 In addition to revising and generally up-dating these pronouncements, the APB is taking the opportunity to bring them much more closely into line with the corresponding International Standards on Auditing that have been issued by the International Auditing Practices Committee.

4.6 During the course of 1993, five batches of exposure drafts of the revised pronouncements have been issued, including some 22 proposed SASs. It is expected

that these documents will be finalised by the middle of 1994.

Auditors' duty to report to regulators

4.7 The Government has announced its decision to introduce a new statutory duty for auditors to report certain information direct to financial sector regulators. The duty will apply to auditors of banks, building societies, insurance companies, investment business and friendly societies. A consultation paper issued in the Spring 1993 set out the proposed legislation.

4.8 The APB agreed to develop standards and guidance for auditors on this new duty, to be available by the time the new legislation is introduced (projected for end-1993).

4.9 An exposure draft of a SAS, setting out the principles that apply in each of the five financial sectors, was issued by the APB in July. Comments received are now being considered.

4.10 In addition, a series of five Practice Notes, giving detailed guidance to auditors in each of the five areas on the application of the general principles, is currently being developed.

4.11 It is expected that the new SAS, together with the supporting Practice Notes, will be finalised and published early in 1994.

Implications for auditors of the Cadbury Report

4.12 The Cadbury Report recommended guidance be developed for auditors of listed companies on their:

- review of the directors' statement of compliance with the Code of Best Practice (the Cadbury Code);
- report on the directors' statements on going concern and the effectiveness of internal controls;
- review of the interim financial information.

Bulletins providing guidance for auditors on each of these areas are now being developed by the APB. Guidance on the review of interim financial information is expected in November.

4.13 The APB has also developed and issued an exposure draft of a proposed SAS on 'Consideration of law and regulations'; the Cadbury Report recognised this as an area which presented 'a number of difficult issues', not least because auditors are unlikely to have appropriate expertise to identify and investigate suspected illegal acts.

Assessment of the first three years

5.1 How far the first three years of the operation of the Council, the Accounting Standards Board and the Financial Reporting Review Panel can be counted a success can only be fully answered in the years ahead as we see the impact for good they have had on the quality of financial reporting. The initial signs are encouraging. But there is still much ground to be covered, some of it dauntingly difficult.

5.2 Of course, most new systems are afforded a breathing space before they are put fully to the test, and major challenges lie ahead. The tasks on the ASB's agenda are getting progressively tougher; and as the honeymoon wanes critics are likely to feel less and less inhibited about moving on to the attack. Nevertheless, good foundations have been laid.

5.3 During the past three years the Council has seen the financing of the organisations put on an on-going basis. We still - rightly - need to demonstrate to our financial supporters that their contributions continue to be justified but, without diminishing the importance of the support we receive from Government, which we greatly value, we welcome the achievement of a system of support of which two thirds comes from the private sector.

5.4 Through its Annual Review and by direct approaches the Council has tried to ensure that those concerned with good financial reporting have been kept fully informed about the new system and its progress. Through its Chairman the Council has looked for some phasing of proposals for change by various bodies concerned with financial reporting, so as to respond to concerns about 'overload'.

5.5 As one of the sponsors of the Cadbury Committee the Council has sought to widen the financial reporting perspective to include its corporate governance aspects.

5.6 Not least, throughout the past three years, the Council has lent strong support and encouragement to the ASB and the Review Panel. It will continue to do so.

5.7 The Accounting Standards Board has a crucial role to play in helping to improve the credibility and international standing of UK financial reporting. From the start it took the view that standards must be based on principles and that it would adopt an evolutionary approach to standard-setting, seeking by a process of full public consultation to achieve a consensus for the changes proposed. Though the ASB inherited from its predecessor body a heavy legacy of work in progress, its programme

has reflected its own choice of priorities agreed with the Council. Two of its first three Financial Reporting Standards - FRS1 and FRS 3 - have changed the face of accounts by introducing new primary statements, giving users of accounts much more useful information about the company's performance and financial position. In particular the reshaping of the profit and loss account and the greater disclosure of reserve movements brought about by FRS 3 have widened the horizon away from a mechanistic preoccupation with a single earnings number to a more intelligent interpretation of results based on the use of the whole information set now made available.

5.8 We applaud the ASB also for its determination to base its standards on principles rather than detailed rules, and to develop a Statement of Principles as a backcloth to this approach. If this approach is to succeed however it will call for the continued willingness of preparers and auditors of accounts to abide by the principles and not seek to take advantage of them. If the approach based on principles were to fail the ASB would be driven to a rule-book approach that, while it might in the short term bring benefits to some, in the longer term would be to the benefit of nobody. We hope therefore that good sense will continue to prevail.

5.9 The ASB has been criticised in some quarters for its apparent slowness in producing only three standards over the past three years. However, the ASB recognises that change is burdensome, and should therefore be introduced only when it is essential. Moreover, the ASB acknowledges that its commitment to thorough preparation of new standards, with full consultation at each stage of development, together with field trials where appropriate, itself imposes burdens on those who are willing to assist the ASB's work. As other sections of this survey indicate, there is concern about an 'overload' on finance directors and others of proposals for comment or measures to be implemented. In response to that concern the ASB will, as far as is practicable, play its part in seeking to ensure that its output comes forward in an orderly way, and it has stated that generally it would not expect to produce more than two standards a year The ASB will continue to ensure that an adequate period of time is allowed for comment on its proposals. Subject to these considerations, however, we regard it as essential that the ASB should not be diverted from its programme of activity.

5.10 We believe that the ASB's statement on Operating and Financial Review is a useful guide in its own right to making annual reports more informative and intelligible to users. In particular it allows management to discuss events affecting their business during the reporting year that would not recur and those expected in the forthcoming

period. It enables discussion to take place on the financing of the business, its currency and its credit risks. In general it helps management to give the reader of accounts a fuller picture than could be presented by mere numbers, in an attempt to provide financial communication rather than narrow financial reporting. In addition it will be of help as a vehicle for the implementation of some of the proposals considered in the Cadbury Report.

5.11 Given the subjects that it is about to tackle there seems little doubt that the ASB will soon be facing a major test. Accounting for goodwill, the principles of valuation, and fair values in acquisition accounting in particular seem likely to be highly controversial and to admit of no easy answers. One problem for the ASB is that it is in the nature of things for critics to be more vociferous than supporters. We hope that supporters too will make their views heard in areas of controversy.

5.12 The Urgent Issues Task Force is playing an increasingly important part in assisting the ASB - a clear demonstration of the willingness of those concerned to help to find solutions.

5.13 In last year's Annual Review the Council recorded its disappointment that the accounting profession and companies had not been bringing issues to the Task Force for a ruling before a position was taken. The ASB has subsequently received requests for clarification of the nature of the issues that it expects to be raised in this way.

5.14 Since the Task Force meets normally every two months - though with the possibility of reducing the interval to one month for emergencies - there are obvious limits both to the number of issues it can deal with and to the speed with which it can reach a conclusion. Moreover, it would not be desirable that the Task Force should come to be seen as a normal route for resolving the many difficult issues of judgement that arise in the course of the preparation and audit of company accounts. Nevertheless there are times when a serious issue arises in a form that will quickly set a precedent for others facing similar or analogous situations. In some of these instances an informal and unbiased reading of the law, relevant accounting standards and UITF Abstracts may indicate what needs to be done, even though reliance may have to be placed on applying the spirit of a standard when the letter does not precisely fit the case in hand. The ASB drafts its standards to deal with the generality of cases rather than every conceivable variant and expects their spirit to be applied. In some instances, however, there may be genuine doubt over the most appropriate accounting treatment to give a true and fair view. The Council repeats its invitation issued last year that companies with their auditors should bring forward substantial new issues of

this kind for consideration by the Task Force.

5.15 In the international field the ASB is endeavouring to play its part in ensuring that international and domestic development as far as possible march in the same direction.

5.16 It is pleasing to note the excellent co-operation that has been established with the Institute of Chartered Accountants in Ireland on the application of the ASB's proposals in the Republic.

5.17 As was noted in last year's survey, the very presence of the Financial Reporting Review Panel has been a clear force for good in the field of financial reporting, and, not least, it is to its credit that it has not so far been obliged to seek recourse to the court. It is not without its critics, but a body at the sharp end of regulation cannot expect it to be otherwise if it is being effective. Nevertheless the Panel considers very carefully all the points voiced.

5.18 One difficulty is that there are frequently conflicting considerations to be accommodated. Thus some argue that the Panel has been too rigorous in its approach, while others take the view that it has been too lenient. One of the most difficult tasks for the Panel is to determine the appropriate voluntary remedial action in any particular case.

5.19 Some have argued that the Panel has been unduly preoccupied with small companies. But the Panel does not believe that it would be right, in the interests of investors, to ignore complaints put to it about a company within its ambit on the grounds that the company was insufficiently large. At the other end of the scale the Panel feels that it would be quite wrong for it to engage in fishing expeditions among the largest in order to redress the balance. The starting point must be some clear indication that something may be amiss.

5.20 The Panel's recently revised Procedures should be of benefit both to the companies it enquires into and to the Panel in enabling it to operate in a more informal way than hitherto in the early stages of an enquiry.

5.21 The cases coming before the Panel have reflected a range of accounting topics. To the extent that the issues manifest any pattern, failure to observe the requirements of consistency, failure to provide the information required by the legislation or

accounting standards, and simple error have each been a feature.

5.22 As with the ASB, it may well be that the greatest challenges for the Panel lie ahead, perhaps particularly if its deterrent force should become blunted through familiarity. Only time will tell.

5.23 While formal responsibility lies elsewhere the Council's interest in good financial reporting has naturally led it to note the problems faced by the auditing profession. It seems to the Council that not the least of these is the question of the auditor's exposure to suits for damages and the accompanying problem of insuring against this potential liability. It cannot be in the interests of good financial reporting for there to be a strong possibility that auditors will decline to act for clients whom they perceive to be of high risk. In the interests of all parties, including government, we are clear that the problem needs to be addressed urgently .

Conclusion

5.24 Summing up this assessment, the ASB, the Review Panel and the Urgent Issues Task Force have made a good start. For the ASB and probably the Review Panel the greatest challenges are yet to come.

5.25 The task ahead should not be underestimated. The ASB has a formidable programme before it, and as the days go by new issues, including those thrown up by Review Panel enquiries, point to the need for revision of existing accounting standards or the development of new ones. But the ASB's resources are limited, and this pressure for change has to be structured so as to draw on the expertise of those concerned in an orderly way.

5.26 As implied earlier in this section, we believe that the success of the present system of developing accounting standards turns crucially on the voluntary support of those affected by them. If this voluntary support were lost the alternative could, as indicated in our last Review, only be a greater and more detailed rigidity. Based on our experience to date we have every confidence that the new system will continue to receive the wide measure of support it has so far secured.

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