chapter 17

Expansion of the annual report

overview

The size of the annual reports of companies, particularly those of listed companies, has grown substantially as directors have chosen to provide much more information than is required by law. While much of this increased disclosure has been required or encouraged by the Stock Exchange and the ASB, much is provided voluntarily. It seems likely, on the basis of the Government White Paper, *Modernising Company Law*, published in July 2002, that there will be a considerable increase in the amount of information required by law. In this chapter, we examine a number of statements with which accountants need to be familiar, namely:

- Cash Flow Statement
- Operating and Financial Review
- Historical Summary
- Reporting about and to employees
- Summary Financial Statement

We therefore draw upon the following official pronouncements:

- FRS 1 *Cash Flow Statements* (revised 1996)
- IAS 7 *Cash Flow Statements* (revised 1992)
- ASB Statement *Operating and Financial Review* (1993)
- ED *Revision of the Statement Operating and Financial Review* (2002)

The Accounting Standards Board has also attempted to regulate other parts of the annual reporting package of listed companies and we shall conclude with a brief look at two recent ASB Statements:

- *Interim Reports* (1997)
- *Preliminary Announcements* (1998)

We outline the changes proposed by the White Paper in relevant sections of the chapters.

Introduction

Traditionally a set of accounts, as financial statements used to be described, consisted of just two statements albeit supported by, often voluminous, notes. The balance sheet summarised the position at the end of an accounting year while the profit and loss account explained what had happened since the previous balance sheet. Neither document pretended to tell the whole story and, in particular, the profit and loss account was uncomfortable about reporting increases in value not caused by operations. We have seen, in earlier chapters, how accounting practice has developed to deal with some of the deficiencies of the traditional approach by the introduction of a new primary statement, the Statement of Total

Recognised Gains and Losses, and a requirement for a Reconciliation of Movements in Shareholders' Funds. We have also examined proposals to replace the profit and loss account and statement of total recognised gains and losses by a single performance statement.[1] Such statements serve to provide a more coherent description of how things have changed but remain firmly based on the traditional reporting model.

In this chapter, we will discuss some different approaches to reporting. The differences come in varying forms. Some of the statements which we will consider, such as the Cash Flow Statement, try to provide a different perspective on what has happened during the year. Others, such as the historical summary and operating and financial review, provide a context for the current year's report. Other statements, such as the simplified statements prepared for shareholders and employees, attempt to address the needs of particular user groups. Yet other reports, namely interim reports and preliminary announcements, seek to provide users with more timely information.

While the statements discussed in this chapter share the common feature that they are not at present required by company law, they are certainly not all produced on a consistent basis. Some are widespread because they are required by the Stock Exchange or the Accounting Standards Board (ASB); examples of these are Interim Reports and Cash Flow Statements. Others are produced by some companies but not by others; examples are historical summaries, operating and financial reviews and simplified reports. However, all of these statements provide an important and different perspective on the activities of a company and are therefore all worthy of examination.

In broad terms the objectives of most additional statements are the same – to assist the users of financial statements to obtain a more comprehensive view of the progress and future prospects of the company. This broad objective can be served in a number of ways and it is helpful to have a framework within which the statements can be analysed. Essentially the statements can be seen as constituting two groups, depending on whether a statement:

(a) provides more data than are required by company law, or
(b) does not provide additional data but makes it easier to assimilate the data either by rearrangement of the figures or through the provision of simplified statements.

We might usefully refer to the first group as 'extended' statements and the second as 'rearranged and simplified' statements.

Extended statements include such documents as the Cash Flow Statement and Employment Report as well as the Operating and Financial Review.

Rearranged and simplified statements can be derived from the published financial statements of the company, except in the case of smaller companies, and include such documents as the simplified report to employees and the Summary Financial Statement which may be sent to the shareholders of listed companies.

It is interesting to question why companies should be required or should choose to publish such rearranged and simplified statements. In part, the reason may be behavioural in the sense that the publication of the document is intended to create better relations with employees and the community in general. Such an objective is clearly present in the case of simplified financial statements prepared especially for employees. Another possible reason is the wish to remove the 'competitive advantage' possessed by investors and potential investors who have technical knowledge themselves or have ready access to professional advice.[2]

[1] See Chapter 11, pp. 292–6.

[2] Supporters of the 'efficient market hypothesis' which, in its semistrong form, states that all available data relevant to the price of a share are immediately reflected in the market price, would presumably take the view that there is nothing to be gained from any requirement for companies to publish otherwise available data in a different form.

The first major developments in the drive towards the expansion of the annual report came in 1975 when the Accounting Standards Steering Committee issued both SSAP 10 *Statements of Source and Application of Funds*, and *The Corporate Report*.[3] SSAP 10 required all but very small enterprises to prepare a statement of source and application of funds as part of their audited financial accounts. It has since been superseded by FRS 1 *Cash Flow Statements,* first issued in September 1991 but subsequently revised in October 1996. *The Corporate Report* argued that the then current reporting practices did not fully meet the needs of the various users of accounts and recommended that all significant economic entities should publish the following additional statements:

(a) a statement of value added;
(b) an employment report;
(c) a statement of money exchanges with government;
(d) a statement of transactions in foreign currency;
(e) a statement of future prospects;
(f) a statement of corporate objectives.

The adoption of these recommendations would have resulted in the provision of substantially more information than that provided by the statutory financial accounts. While *The Corporate Report* remains an important document worthy of study, none of these recommendations has in fact been adopted by the ASC or ASB except to the the extent that some companies are encouraged to prepare an Operating and Financial Review, which is concerned in part with future prospects.

Even without legislative requirements, it is clear that the accountant must develop competence in producing and interpreting statements other than the traditional balance sheet and profit and loss account. In this chapter, we concentrate on the Cash Flow Statement and then examine, more briefly, the Operating and Financial Review, the Historical Summary, the subject of reporting about and to employees and the Summary Financial Statement which listed companies may send to their shareholders instead of the full financial statements. Finally, we examine the recent attempts of the ASB to regulate Interim Reports and Preliminary Announcements.

The Government White Paper, *Modernising Company Law*, published in July 2002,[4] makes a number of proposals in this area, which we outline in the relevant sections.

Cash flow statements

Background

It has long been recognised that the information provided by a balance sheet and profit and loss account gives users limited help in understanding how the liquidity of a company or group has been affected by its activities during a particular year. To remedy this, accounting standard setters in many countries required companies to prepare 'funds statements', that is statements showing the sources and applications of funds. So, in the UK, SSAP 10 *Statement of Source and Application of Funds*, first issued in July 1975, required all but the smallest companies to prepare such a statement.

[3] Accounting Standards Steering Committee, *The Corporate Report*, London, 1975.
[4] Cm. 5553-I and II.

One of the first difficulties which companies encountered in complying with SSAP 10 was that, although the statement defined net liquid funds as one component of funds, it did not actually define the term funds. As with profit, there are many possible definitions of funds including cash, working capital and all financial resources. The choice of definition determines what the statement seeks to explain and hence what is shown as a source or application. To take a simple example, the receipt of cash from debtors is a source of funds if the cash concept is adopted, but merely a change in the constituent parts of funds if the working capital concept is used. As a second example, the issue of shares in exchange for the purchase of fixed assets is neither a source nor an application if either the cash or working capital concepts are used, but it certainly changes the financial resources of a company.

In the USA, the funds statement had long been the subject of criticism[5] and, in November 1987, the FASB replaced the requirement for US companies to produce a funds statement with a requirement for them to produce a statement of cash flows, Statement of Financial Accounting Standards number 95, *Statement of Cash Flows*, which requires relevant US companies to prepare a statement explaining the change in cash and cash equivalents by showing cash receipts and payments.

Both the UK accounting standard setters and the International Accounting Standards Committee drew on this US standard in preparing FRS 1, *Cash Flow Statements* (1991) and IAS 7 *Cash Flow Statements* (1992) respectively. However, FRS 1 was revised in October 1996 and, in the revised version, the ASB has moved some considerable way from both the US and the international approach, which we shall discuss later in the chapter.

FRS 1 requires all relevant UK entities to prepare a Cash Flow Statement as one of its primary financial statements. The revised standard applies to all financial statements intended to give a true and fair view of financial position and profit or loss. Exemptions are, however, given to a number of entities, including small companies, subsidiary undertakings where 90 per cent or more of the voting rights are controlled within the group (provided relevant consolidated accounts are publicly available), as well as more specialised institutions such as pension funds and certain open-ended investment funds.[6]

While there is no legal requirement for companies to prepare a Cash Flow Statement at present, the White Paper, *Modernising Company Law* (July 2002) proposes that such a requirement should be included in the next Companies Act.[7] However, in keeping with its proposals on the form and content of financial statements generally, which we discussed in Chapter 2, the White Paper envisages that the specification of the detailed rules on the form and content of the Cash Flow Statement should be delegated to a new Standards Board. Hence, there is likely to be little change to the Cash Flow Statement as a consequence of any new legislative requirement for such a statement.

We turn first to the preparation of a Cash Flow Statement for a single company.

FRS 1 and the individual company

The objective of FRS 1 is to ensure that the reporting entities falling within its scope:

(a) report their cash generation and cash absorption for a period by highlighting the significant components of cash flow in a way that facilitates comparison of the cash flow performance of different businesses; and

[5] See, for example, Loyd C. Heath, 'Let's scrap the funds statement', *Journal of Accountancy*, October 1978.

[6] FRS 1 *Cash Flow Statements* (revised 1996), ASB, London, October 1996, Para. 5.

[7] *Modernising Company Law*, Cm. 5553-I, Para. 4.13.

(b) provide information that assists in the assessment of their liquidity, solvency and financial adaptability. (Para. 1)

To this end, it requires relevant entities to prepare a Cash Flow Statement explaining the change in cash balances during a period. In order to permit comparisons over time and with other businesses, receipts and payments are to be analysed under the nine headings shown below:[8]

Cash flow statement for the year ended 31 December 20X1

	£
Net cash inflow/outflow from operating activities	X
Dividends received from associates and joint ventures	X
Returns on investment and servicing of finance	X
Taxation	X
Capital expenditure and financial investment	X
Acquisitions and disposals	X
Equity dividends paid	X
Cash inflow/outflow before use of liquid resources and financing	X
Management of liquid resources	X
Financing	X
Increase/decrease in cash during year	X

FRS 1 adopts a very narrow definition of cash:

> **Cash in hand and deposits repayable on demand with any qualifying financial institution, less overdrafts from any qualifying institution repayable on demand. Deposits are repayable on demand if they can be withdrawn at any time without notice and without penalty or if a maturity or period of notice of not more than 24 hours or one working day has been agreed. Cash includes cash in hand and deposits denominated in foreign currencies. (Para. 2)**

In requiring companies to explain the change in cash during a period, the revised FRS 1 introduced the first true 'cash' flow statement. The original FRS 1, like the US standard 94 and the international standard IAS 7, had required companies to prepare a statement explaining changes in 'cash and cash equivalents'. As we shall explain later, the definition of cash equivalents gave rise to considerable problems in practice and the ASB was unable to develop a satisfactory definition to replace it.

In order to emphasise how the Cash Flow Statement articulates with the profit and loss account and balance sheet, FRS 1 requires that the statement be accompanied by two notes. The first provides a reconciliation between an item in the cash flow statements and one in the profit and loss account while the second provides a reconciliation between the net cash inflow or outflow and items in the opening and closing balance sheet:

1 Reconciliation of net cash inflow/outflow from operating activities with operating profit/loss.

2 Reconciliation of cash flows with the movement in net debt/net funds during the period.

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[8] FRS 1 (revised 1996) required the use of eight headings but this has itself been revised by FRS 9 *Accounting for Associates and Joint Ventures*, which was issued in November 1997. FRS 9 requires the insertion of a new heading, 'Dividends received from associates and joint ventures'.

Net debt is defined in Para. 2 of the Standard, as:

> **The borrowings of the reporting entity (comprising debt as defined in FRS 4 'Capital Instruments' (paragraph 6), together with related derivatives, and obligations under finance leases) less cash and liquid resources. Where cash and liquid resources exceed the borrowings of the entity reference should be made to 'net funds' rather than to 'net debt'.**

With this framework, we shall examine the cash flows to be included under each of the nine main headings.

Net cash flow from operating activities

The net cash flow from operating activities is the cash flow relating to all those activities which are included in arriving at the operating profits of an entity. It is calculated by reference to the cash effects of all transactions relating to operating or trading activities, normally included in the profit and loss account in arriving at operating profit. These include cash flows relating to provisions in respect of operating items, even where the provision was not included in the operating profit of a particular year. So, where a provision is made for the costs of a reorganisation or restructuring in one period but the cash payments take place in a later period, those cash flows must still be included as part of the operating cash flows in that later period (Para. 58).

The net cash flow from operating activities may be calculated either by the direct method (the gross method) or the indirect method (the net method). The direct method is easy to understand as it focuses on the cash received in respect of operating activities and the cash paid out in support of those activities:

Direct method	*£000*
Cash receipts from customers	5250
Cash payments to suppliers	(1685)
Cash payments to and on behalf of employees	(3132)
Net cash flow from operating activities	433

However, this method requires information that is not provided routinely by the accounting systems of most companies, so it is usually easier to derive the net cash flow from operating activities by using the indirect method:

Indirect method	*£000*
Operating profit	444
Adjustments for items not involving a flow of cash:	
Depreciation	85
Increase in stocks	(68)
Increase in debtors relating to operating activities	(55)
Increase in creditors relating to operating activities	27
Net cash flow from operating activities	433

This indirect method effectively reverses all the accruals adjustments, including that for depreciation, which have been made in arriving at operating profit.

As we have explained above, FRS 1 requires companies to publish a note to the Cash Flow Statement reconciling the net cash inflow/outflow from operating activities to the operating

profit. This note is, in fact, the calculation using the indirect method. It is an extremely useful note for both accountants and non-accountants because it helps them to understand why a healthy profit may not lead to a positive cash inflow. While the original FRS 1 sensibly relegated this reconciliation to a note, the revised FRS 1 permits it to be given either adjoining the cash flow statement or as a note. However, it points out clearly that:

> The reconciliation is not part of the cash flow statement; if adjoining the cash flow statement, it should be clearly labelled and kept separate. (Para. 12)

In the view of the authors, this rather subtle point that the first part of a published Cash Flow Statement is a note, rather than a part of the Statement, is likely to be lost on the majority of users!

Dividends received from associates and joint ventures

Following the issue of FRS 9 *Associates and Joint Ventures* in 1997, it is now necessary to include dividends received from associates and joint ventures under this separate heading. Their proximity to the net cash flow from operating activities in the cash flow statement reflects the treatment of the share of the operating profit of such investees in consolidated profit and loss accounts or in the notes or supplementary profit and loss accounts prepared by individual companies.[9]

Returns on investments and servicing of finance

FRS 1 requires the separation of returns on investments and payments to service financing from the capital flows to which they relate. The cash flows under this heading should therefore include the following items:

- interest received, including any related tax recovered;
- interest paid, including any tax deducted and paid to the relevant tax authority (the standard specifically requires the inclusion of interest paid even if it is capitalised and, of course, requires the inclusion of the interest element of finance lease payments);
- dividends received, net of tax credits;[10]
- dividends paid on non-equity shares.

Dividends paid on equity share capital are to be included under a separate heading 'Equity dividends paid' discussed below.

Taxation

The only amounts to be included under this heading are payments and receipts relating to tax on the company's revenue and capital profits. Thus this heading typically comprises payments of corporation tax and similar foreign taxes.

Taxes for which the company acts as a collecting agent for the government, such as VAT, would normally be dealt with as part of the operating activities of the company. Cash flows would then be shown net of any VAT and an adjustment would be made to reflect the change in the amount payable to or recoverable from the government.

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[9] See Chapter 15.

[10] Where foreign dividends are received after deduction of overseas withholding tax, which is recoverable, it would seem appropriate to include the gross amount.

Capital expenditure and financial investment

This heading comprises all payments and receipts in respect of the purchase or sale of fixed assets, whether tangible, intangible or investments in the loans or shares of other entities. It excludes payments and receipts in respect of acquisitions and disposals of trades, businesses and investments in subsidiary undertakings, associates and joint ventures, which must be included under the next heading. However, it includes payments and receipts relating to any current asset investment which is not included in the company's definition of liquid resources. We shall discuss such liquid resources under the heading 'Management of liquid resources' below.

Some commentators had argued that the ASB should require companies to distinguish between capital expenditure incurred to maintain the size of the business and capital expenditure involving expansion. Not surprisingly, the ASB took the view that such a distinction would be difficult both to make and to police.

Acquisitions and disposals

This heading comprises receipts and payments in respect of acquisitions and disposals of trades and businesses as well as purchases and sales of investments in subsidiary undertakings, associates and joint ventures. As we shall see in a later section of the chapter, in dealing with the purchase or sale of subsidiary undertakings in consolidated financial statements, it will be necessary to show separately any balances of cash and overdraft of the subsidiary at the date of acquisition or disposal.

Equity dividends paid

The cash flows to be included here are the dividends paid on the reporting entity's equity shares.

Under the original FRS 1, such dividends were to be shown under the earlier heading 'Returns on investments and servicing of finance', which resulted in a consistent treatment of dividends received and paid as well as of interest received and paid. However, the revised FRS 1 requires that equity dividends paid, typically the dividends paid on ordinary shares, should be shown under this separate heading. The justification for this is presumably the fact that directors have a large measure of discretion over this payment in practice.

Management of liquid resources

Each company must decide and explain which current asset investments are regarded as 'liquid resources'. Liquid resources are defined as follows:

> **Current asset investments held as readily disposable stores of value. A readily disposable investment is one that:**
>
> **(a) is disposable by the reporting entity without curtailing or disrupting its business; and is either**
>
> **(b) (i) readily convertible into known amounts of cash at or close to its carrying amount, or**
> **(ii) traded in an active market. (Para. 2)**

As we have described earlier, the original FRS 1 required that a cash flow statement explained changes in 'cash and cash equivalents', terms which were defined as follows:

> **Cash: Cash in hand and deposits repayable on demand with any bank or other financial institution. Cash includes cash in hand and deposits denominated in foreign currencies.**
>
> **Cash equivalents: Short-term, highly liquid investments which are readily convertible into known amounts of cash without notice and which were within three months of maturity when acquired; less advances from banks repayable within three months from the date of the advance. Cash equivalents include investments and advances denominated in foreign currencies provided that they fulfil the above criteria. (Original FRS 1, Paras 2 and 3)**

Such a definition of cash equivalents attempted to ensure that the amounts receivable were not subject to fluctuations in value as a consequence of interest rate changes. However, the definition attracted an enormous amount of criticism. Many companies argued that it was too restrictive and out of line with their treasury management policies so that cash flow statements prepared using the definition failed to reflect their liquidity and financial adaptability. Although the ASB attempted to develop a new definition of 'cash equivalents', it was unable to develop one which was universally acceptable. Instead it decided to require a real cash flow statement and left it to individual companies to decide which investments they regarded as liquid resources. The revised FRS 1 requires companies to decide and explain which investments are regarded as liquid resources and then to show receipts and payments in respect of such investments under the heading 'Management of liquid resources'.

While this may have been the best approach achievable, it inevitably reduces comparability between companies. In the view of the authors, it is particularly unfortunate that the ASB has provided a definition of 'liquid resources' which excludes cash, the most liquid of all resources. The use of the term 'liquid investments' would surely have been more appropriate for its intended use!

Financing

This heading comprises the capital receipts from and payments to external providers of finance. Typical examples would be receipts from issuing shares or debentures and payments to repay loans and purchase or redeem share capital. However, the heading would also include receipts and payments in respect of short-term borrowing, except overdrafts, as well as payments of issue expenses and the capital element of finance lease rental payments.

The revised standard specifically permits the section for Financing to be combined with that for the Management of liquid resources, provided that separate sub-totals for each are provided.

With this summary of the cash flows to be included under each heading, we are now in a position to look at an example. We shall illustrate the preparation of a Cash Flow Statement supported by the two notes required by the revised FRS 1.

Example 17.1

The summarised financial statements of a manufacturing company, Kamina plc, for the year ended 31 December 20X2, together with an opening balance sheet, are given below. The two right-hand columns by the balance sheet merely list differences between the opening and closing balances. The '+' column contains increases in assets and reductions in liabilities, while the '–'column contains reductions in assets and increases in both liabilities and the shareholders' interest.

Balance sheets on 31 December 20X1 and 20X2

	20X1	*20X2*	*Change* +	–
	£000	£000	£000	£000
Fixed assets				
Tangible – at net book value (note (i)):				
Freehold properties	800	1140	340	
Plant and machinery	1100	1400	300	
Investments at cost	100	110	10	
	2000	2650	650	
Current assets				
Stock	1100	1680	580	
Debtors (note (ii))	490	730	240	
Government securities – at cost	150	250	100	
Cash at bank	200	–		200
	1940	2660		
less Short-term creditors				
Bank overdraft	–	85		85
Creditors (note (iii))	735	970		235
Taxation payable (note (iv))	155	205		50
Proposed dividend	140	160		20
	1030	1420		
Net current assets	910	1240		
	2910	3890		
less Long-term loans (note (v))	600	1000		400
	2310	2890		
less Deferred taxation (note (vi))	380	479		99
	1930	2411		
			1570	1089
Share capital and reserves				
£1 ordinary shares (note (vii))	1000	1100		100
Share premium (note (vii))	200	300		100
Retained profits	730	1011		281
	1930	2411	1570	1570

Profit and loss account for the year ended 31 December 20X2

	£000	£000
Turnover		6250
Cost of sales		3750
Gross profit		2500
Distribution costs	615	
Administrative expenses	1064	1679
Operating profit		821
Profit on sale of freehold property		40
		861
Dividend received		5
Interest received		12
		878
Interest payable (note (viii))		98
Profit on ordinary activities before tax		780
Taxation		
Corporation tax	180	
Deferred tax	99	279
Profit on ordinary activities after tax		501
less Equity dividends		
Paid	60	
Proposed	160	220
Retained profit for the year		281

Notes

The following information is relevant:

(i) Fixed asset movements

	Freehold properties	*Plant and machinery*
	£000	£000
Cost		
On 1 January 20X2	1000	2000
Additions	440	720
Disposal	(60)	–
On 31 December 20X2	1380	2720
Depreciation		
On 1 January 20X2	200	900
Disposal	(10)	–
Profit & loss account charge	50	420
On 31 December 20X2	240	1320
Net book value 31 December 20X2	1140	1400
31 December 20X1	800	1100

(ii) A freehold property was sold for £90 000 and, at 31 December 20X2, £75 000 of this amount is included in debtors.

(iii) Short-term creditors have been analysed as follows:

	31.12.20X1	*31.12.20X2*
	£000	£000
Interest payable – £600 000 11% loan	33	33
£400 000 10% loan	–	10
Creditor for purchase of machinery	40	60
Trade and expense creditors	662	867
	735	970

(iv) Taxation payable has been analysed as follows:

	31.12.20X1	*31.12.20X2*
	£000	£000
Corporation tax payable	80	95
Value added tax	75	110
	155	205

(v) Long-term loans

	31.12.20X1	*31.12.20X2*
	£000	£000
11% loan	600	600
10% loan raised 1 April 20X2	–	400
	600	1000

Interest on the 11 per cent loan is payable annually on 30 June while interest on the new 10 per cent loan is payable half yearly on 30 September and 31 March.

(vi) Deferred taxation

	31.12.20X1	*31.12.20X2*
	£000	£000
Deferred taxation on timing differences	380	479

(vii) Share issues
40 000 £1 ordinary shares were issued for cash of £80 000 on 5 December 20X2 while a further 60 000 £1 ordinary shares were issued on 12 December 20X2 to acquire a freehold property valued at £120 000.

(viii) Interest payable is made up as follows:

	£000
Interest on long-term loans	
11% loan	66
10% loan (from 1 April 20X2 to 31 December 20X2)	30
	96
Interest paid on bank overdraft	2
	98

We shall now examine the workings for this example in detail. We shall assume that Kamina plc considers the current asset investment in government securities to be a liquid resource.

(A) Change in cash

	£000
Cash at bank on 1 January 20X2	200
Bank overdraft on 31 December 20X2	85
Decrease in cash	285

(B) Net cash inflow from operating activities using indirect method

	£000	£000
Operating profit		821
Adjustments:		
Depreciation – freehold buildings (note (i))	50	
– plant & machinery (note (i))	420	470
Increase in stocks		(580)
Increase in debtors from operating activities:		
per balance sheet on 31 December 20X2	730	
less debtor for sale of property (note (ii))	75	
	655	
per balance sheet on 31 December 20X1	490	(165)
Increase in creditors from operating activities:		
Trade and expense creditors per note (iii) (867 – 662)	205	
VAT per note (iv) (110 – 75)	35	240
Net cash inflow		786

Note: It is not necessary to deduct the profit on sale of the freehold property as this has not been included in arriving at the operating profit shown in the profit and loss account.

(C) Returns on investments and servicing of finance

	£000	£000
Interest paid (see notes (v) and (viii))		
On £600 000 11% loan		
Amount paid 30 June 20X2	(66)	
(Check 33 000 + 66 000 – 33 000)		
On £400 000 10% loan		
Amount paid 30 September 20X2		
$\frac{1}{2} \times 10\% \times 400\,000$	(20)	
(Check 0 + 30 000 – 10 000)		
	(86)	
On bank overdraft (interest paid)	(2)	
		(88)
Interest received		12
Dividends received		5
Net payments		(71)

(D) Taxation – corporation tax

	£000
Corporation tax paid during year	
Opening creditor per note (iv)	80
Profit and loss account charge	180
	260
less Closing creditor per note (iv)	95
	165

(E) Investing activities

	£000	£000
Purchases of fixed assets using cash		
Freehold properties – additions per note (i)	(440)	
less Purchased by means of share issue per note (vii)	(120)	
Cash purchases		(320)
Plant and machinery – additions per note (i)	(720)	
less Increase in creditors for plant and machinery purchases per note (iii) (60 000 – 40 000)	20	
Cash purchases		(700)
		(1020)
Sale of fixed assets – freehold property		
Net book value per note (i) (60 000 – 10 000)	50	
add Profit on disposal – per profit & loss account	40	
Proceeds as given in note (ii)	90	
less Debtor at 31 December 20X2	75	15
		(1005)

(F) Equity dividends paid

	£000	£000
Dividend proposed at 31 December 20X1		140
add Dividends per profit & loss account:		
Paid	60	
Proposed	160	220
		360
less Dividend proposed at 31 December 20X2		160
Equity dividends paid		200
Check: Final dividend for 20X1	140	
Interim dividend for 20X2	60	
	200	

(G) Management of liquid resources

	£000
Payment to acquire government securities (£250 000 – £150 000)	100

(H) Financing

	£000
Issue of ordinary shares for cash per note (vii)	80
New long-term loan – per note (v)	400
	480

(I) Change in net debt

The second note to the Cash Flow Statement must show why the net debt has changed, thus linking the cash flow statement to the opening and closing balance sheets. In our example, the note must therefore explain why the net debt has changed from £250 000 to £835 000, an increase of £585 000:

	31.12.20X1	*31.12.20X2*
	£000	£000
Long-term loans	600	1000
Bank overdraft	–	85
less Cash at bank	(200)	(–)
Liquid resources	(150)	(250)
Net debt	250	835

There are three reasons for this change:

	£000
Decrease in the cash balance per (A)	285
New long-term loan per (H)	400
	685
less Purchase of liquid resources per (G)	(100)
	585

We are now in a position to prepare the cash flow statement and accompanying notes.

Kamina plc
Cash flow statement for the year ended 31 December 20X2

	£000	£000
Net cash inflow from operating activities		786
Returns on investment and servicing of finance:		
Interest received	12	
Interest paid	(88)	
Dividends received	5	(71)
Taxation:		
Corporation tax paid		(165)
Capital expenditure and financial investment:		
Payments to acquire tangible fixed assets	(1020)	
Receipts from sales of tangible fixed assets	15	
Payment to purchase fixed asset investment (110 000 – 100 000)	(10)	(1015)
Equity dividends paid		(200)
Cash outflow before use of liquid resources and financing		(665)
Management of liquid resources		
Purchase of government securities		(100)
Financing		
Proceeds from issue of ordinary shares	80	
Proceeds from new loan	400	480
Decrease in cash during the year		285

Notes to the cash flow statement

1 Reconciliation of operating profit to net cash flow from operating activities (see Working (B):

	£000
Operating profit	821
Depreciation of tangible fixed assets	470
Increase in stocks	(580)
Increase in debtors from operating activities	(165)
Increase in creditors from operating activities	240
Net cash inflow from operating activities	786

2 Reconciliation of net cash flow movement to movement in net debt:

	£000
Decrease in cash during the year	285
New long-term loan raised	400
Purchase of government securities	(100)
Increase in net debt resulting from cash flows	585
Net debt at 31.12.20X1 (see below)	250
Net debt at 31.12.20X2 (see below)	835

Net debt at 31 December	*20X1*	*20X2*
	£000	£000
Loans	(600)	(1000)
Cash balances/overdrafts	200	(85)
Liquid resources	150	250
Net debt	(250)	(835)

The cash flow statement which we have prepared shows that, although there was a positive net cash inflow from operating activities of £786 000, there has been a net cash outflow before the use of liquid resources and financing amounting to £665 000. This is due to net interest paid, net dividends paid and corporation tax paid but, principally, to the fact that net payments to acquire fixed assets amounted to £1 015 000.

Kamina plc has raised £480 000 by issuing shares for cash and taking a new loan. However, it has invested £100 000 in liquid resources. The net effect is that cash balances have fallen by £285 000 during the year.

Now that we have explored the preparation of a cash flow statement for an individual company, we turn to the additional considerations posed by the existence of subsidiaries, associates, joint ventures and foreign currencies.

Groups, associates and joint ventures

Groups

Where a company has subsidiary undertakings and prepares consolidated financial statements, the cash flow statement will reflect the cash flows of the group.

Following the normal consolidation techniques of acquisition accounting, which we discussed in Chapters 13 and 14, a consolidated balance sheet includes the whole of the assets and liabilities of the parent undertaking and subsidiary undertakings even when those subsidiary undertakings are only partly owned. The cash flow statement will therefore explain changes in the cash of all the undertakings in the group as shown in the consolidated balance sheets. Intercompany cash flows, resulting from sales, management charges or dividend payments between group companies, are irrelevant although dividends paid to any minority interests will, of course, be shown as a payment under the heading ‘Returns on investments and servicing of finance’.

Where the parent company uses the direct or gross method to determine the cash flows from operating activities of the group, it will be necessary to have in place a system to collect the relevant information from subsidiaries and to ensure that intergroup cash flows are eliminated. Where the indirect or net method is used, it will be possible to rely largely on the adjustments made during the consolidation process although, even in this case, certain additional information will be necessary. Examples of such additional information are analyses of group debtors and creditors, so that those relating to operating transactions can be identified and changes therein included in computing the net cash flow from operations, while those relating to non-operating transactions can be dealt with in computing receipts and payments included under other headings of the statement.

When a company acquires a new subsidiary undertaking, and acquisition accounting is used, the consolidated profit and loss account will include the profits or losses of that new

subsidiary from the date of acquisition to the end of the period, and the consolidated balance sheet will include the whole of the assets and liabilities of the subsidiary, whether it is wholly or partly owned.[11] It follows that when we try to determine the reasons for differences between items in the opening and closing balance sheets, we find that part of the change will be due to the assets, liabilities and any minority interest of the subsidiary undertaking at the date of acquisition as well as to the payment made to acquire the subsidiary. So, for example, if we focus on the change in cash between the beginning and end of the year, we find that part of the change is due to a cash payment made by the parent company to acquire the new subsidiary, and a further part is due to the balance of cash held by the subsidiary at the date of acquisition. The cash payment which must be shown in respect of the purchase of subsidiary undertakings under the heading 'Investing activities' is therefore calculated as follows:

	£000
Cash consideration paid	x
less Cash of subsidiary undertakings at date of acquisition	x
Cash payment	x

Where a subsidiary is acquired for a consideration other than cash, all that will appear in the cash flow statement will be the cash balances of the subsidiary at the date of acquisition.

To enable users to understand what has happened, it is necessary to provide a note to the cash flow statement showing a breakdown of the assets and liabilities acquired, together with the consideration paid. Such a note would take the following form:

Purchase of subsidiary undertakings

	£000
Net assets acquired:	
Tangible fixed assets	16 000
Investments	40
Stocks	13 000
Debtors	5 000
Cash at bank and in hand	2 500
Bank overdrafts	(1 000)
Other creditors	(5 500)
Loans	(3 000)
Minority interests	(40)
	27 000
Goodwill	3 000
	30 000
Satisfied by:	
Shares allotted	25 000
Cash	5 000
	30 000

[11] See Chapter 14.

The analysis of net outflow of cash in respect of the purchase of subsidiary undertakings would be:

	£000	£000
Cash consideration		5000
Cash acquired		
Cash at bank and in hand	2500	
Bank overdraft	(1000)	1500
Net payment		3500

When a group disposes of a subsidiary undertaking the converse is the case. Any cash proceeds from the sale of shares in the subsidiary, less any positive balance of cash of the subsidiary at the date of disposal, will be recorded as a cash receipt under the heading 'Investing activities'. A note to the statement should then provide a list of the assets and liabilities of the subsidiary at the date of disposal together with the proceeds received and any profit or loss on disposal:

	£000
Net assets disposed of:	
Tangible fixed assets	5000
Stocks	2000
Debtors	3000
Cash	1000
Creditors	(4000)
	7000
Profit on disposal	1000
	8000
Satisfied by:	
Loan stock	4000
Cash	4000
	8000

The net cash receipt from the disposal of the subsidiary would be:

	£000
Cash received	4000
less Cash balances of subsidiary sold	1000
	3000

Associates and joint ventures

When an investing company purchases or sells its interest in an associate or joint venture, any payment or receipt of cash will be included under the heading 'Investing activities'.

As we saw in Chapter 15, standard accounting practice requires the use of the equity method of accounting for associates and joint ventures. Under the equity method of accounting, an investing company takes credit in its consolidated profit and loss account for

its full share of the profits or losses of the associate or joint venture. The consolidated balance sheet includes the investment but the individual assets and liabilities do not include relevant amounts in respect of the associated undertaking. Hence cash in the opening and closing consolidated balance sheets do not include the respective amounts for the associate or joint venture.

Apart from the purchase and sale of an investment and, perhaps, the making and repayment of a loan, the only recurrent receipt from an associate or joint venture will be the dividend received. This should be shown as a receipt under the separate heading, 'Dividends received from associates and joint ventures', a heading which has been inserted into the Cash Flow Statement by FRS 9 *Associates and Joint Ventures*, issued in November 1997.

Foreign currency differences

As we have seen in Chapter 16, exchange differences frequently arise both when a company engages in foreign transactions and when the accounts of an overseas entity are translated prior to the preparation of consolidated financial statements. We shall examine the treatment of such differences in the preparation of a cash flow statement. Where a company enters into a foreign currency transaction then, unless there is an agreed rate for settlement or a forward exchange contract, the foreign currency amount will be translated into sterling at the rate on the transaction date. Any difference arising on monetary items between the date of the transaction and the date of settlement will be taken to the profit and loss account as part of the operating profit. Where a debtor or creditor is outstanding at a balance sheet date, the foreign currency amount will be retranslated at the closing rate and again any resulting difference on exchange will be taken to the profit and loss account as part of operating profit.

As far as the cash flow statement is concerned, the cash flows to creditors or from debtors are the amounts actually paid and received in sterling and, if a company wishes to use the direct method to calculate the cash flow from operations, it must ensure that it has an adequate accounting system in place to collect this information. However, it is possible to use the indirect method although it will then be necessary to analyse the difference on exchange which has been included in arriving at operating profit. To the extent that the differences on exchange relate to operating activities, no adjustment is necessary. However, to the extent that differences relate to other activities, such as the purchase of fixed assets on credit or the retranslation of a foreign currency loan, this must be removed from the operating profit to arrive at the net cash flow from operating activities.

To illustrate, let us take examples of a settled transaction, that is one where payment has been made, and an unsettled transaction, respectively. A company makes a purchase from an overseas supplier which is recorded in the accounting records at a sterling amount of £15 000. During the same accounting period, settlement is made of £16 500 resulting in a loss on exchange of £1500, which is deducted in arriving at the operating profit shown in the profit and loss account. The cash payment is, of course, £16 500 and this is the amount which has been deducted in arriving at operating profit, albeit in two parts:

	£
Purchase	15 000
Loss on exchange	1 500
	16 500

Turning to an example of an unsettled transaction, let us assume that a company makes a sale, denominated in foreign currency, to an overseas customer and that the foreign currency amount invoiced is translated at £24 000. If the amount is still due at the ensuing balance sheet date, it will be translated at the closing rate of exchange to produce a different amount of, say, £26 000. The gain on exchange of £2000 will be credited to the profit and loss account in arriving at the operating profit.

As far as the cash flow statement is concerned, there has been no receipt. If we take the operating profit and make the usual adjustment for the change in debtors, this is exactly what will be included in the net cash flow from operating activities:

	£
Operating profit (including gain on exchange):	
Sale	24 000
Gain on exchange	2 000
	26 000
less Increase in debtors	26 000
Cash flow from this transaction	–

Whereas no adjustment is necessary in respect of exchange differences relating to operating activities such as purchases and sales, adjustments to the operating profit will be necessary in respect of other exchange differences. So, for example, an exchange difference relating to the purchase of a fixed asset on credit or the retranslation of a long-term loan must feature as an adjustment in moving from operating profit to net cash flow from operating activities. In the latter case the exchange difference will also have to be included in the note reconciling the opening balance sheet value of the loan with its closing balance sheet value.

Let us now turn to the translation of the accounts of a foreign subsidiary or associate. Here FRS 1 makes it clear what should be done.

> Where a portion of a reporting entity's business is undertaken by a foreign entity, the cash flows of that entity are to be included in the cash flow statement on the basis used for translating the results of those activities in the profit and loss account of the reporting entity.[12]

The vast majority of companies in the UK use the closing rate/net investment method under which profit and loss account items are translated at average or closing rate and assets and liabilities in the balance sheet are translated at the closing rate. Differences on exchange are taken to reserves and these will relate to opening assets and liabilities and, where an average rate is used in the profit and loss account, to the increase in net assets which has occurred during the year. Such differences thus explain changes in the balance sheet amounts, including the change in cash. The relevant parts of these differences on exchange must be included in the note reconciling opening and closing amounts for cash. Similarly, the relevant parts of the difference on exchange must be included in the note reconciling opening and closing net debt. The parts of the difference relating to such items as opening fixed assets, stocks, debtors and creditors will, of course, appear in relevant notes to the accounts but do not represent any receipt or payment of cash.

Where a company uses the temporal method of translation, exchange differences are taken to the consolidated profit and loss account and their treatment in preparing the cash flow statement will be exactly the same as that explained above for foreign currency transactions

[12] FRS 1, Para. 41.

entered into by the company itself. After all, the purpose of the temporal method is to translate the foreign currency financial statements in such a way that the result is the same as if the investing company had itself entered into the transactions undertaken by the foreign entity.

The international accounting standard

IAS 7 *Statement of Changes in Financial Position* was first issued in 1977 and, like the UK SSAP 10, required enterprises to prepare a statement explaining movements in 'funds'. It was subsequently revised in 1992 and, like FRS 1, now carries the title *Cash Flow Statements.*

IAS 7 requires all enterprises to prepare a Cash Flow Statement and, unlike the UK standard, provides no exemptions for small companies. However the Cash Flow Statement required by the international standard differs from that required by FRS 1 in two major respects.

- IAS 7 requires the Cash Flow Statement to explain the change in 'cash and cash equivalents' which has taken place during a period. Cash and cash equivalents are defined as follows:[13]

  Cash comprises cash on hand and demand deposits.

  Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

  In this respect, IAS 7 is closer to the original FRS 1 (1991) than to the revised FRS 1 (1996), which, as we have explained earlier in the chapter, now has a clear focus on changes in 'cash'.

- IAS 7 requires that the cash flows should be reported under three headings: operating, investing and financing activities respectively. These are defined as follows:[14]

  Operating activities are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.

It is therefore the default category under which all cash flows that cannot be clearly classified as investing or financing activities should be included.

  Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

  Financing activities are activities that result in changes in the size and composition of the equity capital and borrowings of the enterprise.

Clearly, this is a very different set of headings from the nine specified in FRS 1 and poses a number of difficulties for companies attempting to classify their cash receipts and payments. An example of this difficulty is the classification of interest and dividends received and paid. Under which heading should these be included? Are they concerned with operating activities, investing activities or financing activities? IAS 7 makes it clear that they must be classified in a consistent manner from period to period but permits them to be classified as operating, investing or financing activities.[15] In practice, different companies classify their interest and dividends in different ways so it is difficult to see how the provision of such flexibility in the international standard achieves much in the way of improved comparability between companies.

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[13] IAS 7, Para. 6.
[14] *Ibid.*
[15] IAS 7, Para. 31.

There are substantial differences between IAS 7 and FRS 1 and, in the authors' view, the more recent FRS 1 is likely to lead to greater comparability between the Cash Flow Statements of different companies than IAS 7. At the time of writing, there appear to be no plans to revise either IAS 7 or FRS 1 so it is difficult to see how convergence will be achieved in this important area of financial reporting.

Usefulness and limitations of the cash flow statement

Now that we have explored the preparation of a cash flow statement and examined major differences between the UK and international standards, it is time to explore briefly the usefulness and limitations of the statement.

As we saw in Chapter 1, most users are concerned with the future performance of an entity and turn to the financial statements, as well as to other sources, for help in making a judgement about likely future performance. In assessing the cash flow statement, it is therefore necessary to ask how it helps users in this task.

The statement supplements the traditional accounts by focusing on changes in cash in a way which provides answers to many pertinent questions which a user might wish to ask. Examples of such questions are as follows: Has there been an increase or decrease in the cash balance? To what extent has cash been generated by the operations of the company? Are payments of interest, taxation and dividends covered by the net cash inflow from operations? Has cash been used to finance the purchase of fixed assets? To what extent has cash been raised to pay for an acquisition?

Answers to such questions as these undoubtedly help users to assess what has happened and what is likely to happen in future. However, like all the figures shown in financial statements, they cannot be used in isolation but must be interpreted as part of the whole collection of information. This may be illustrated by just one example. A user may look at a cash flow statement and find that there has been a substantial purchase of fixed assets out of cash balances. By itself, this may be a little worrying. However, the failure of long-term finance to cover the purchase of fixed assets in a particular year may merely reflect the fact that there were large cash balances at the opening balance sheet date, balances which have now been reduced to more appropriate levels!

The Cash Flow Statement is an enormous improvement on its predecessor, the Statement of Source and Application of Funds, and the Cash Flow Statement required by the revised FRS 1 (1996) improves still further that required by the original FRS 1 (1991). Its clear focus on changes in cash and its treatment of 'liquid resources' are to be applauded. However, it is not without some problems.

First, as we explained above, the focus of the revised FRS 1 on cash and its requirement to list cash flows under nine headings is even more out of line with the international accounting standard than the original FRS 1. There is thus a lack of comparability of Cash Flow Statements in the international arena and there appear to be no plans to achieve convergence, even in the European Union, in the near future.

Second, the need to include both receipts and payments under standard headings frequently results in a statement which is riddled with brackets and which may therefore be confusing to users.

Finally the authors have reservations about the introduction of a definition of 'liquid resources', which excludes cash, the most liquid of all resources! In our view, the term 'liquid investments' would better fit the bill.

The operating and financial review

As a consequence of changes in company law and of the work of the standard setters, the annual financial statements of companies have expanded out of all recognition over the past thirty years or so. While this has ensured that a large volume of mainly quantitative information is available to investors and other users of the statements, it has been argued that it would help users to understand this information better if the directors were to put the information into context by explaining what is happening and by interpreting the financial statements for their benefit. After all, the directors have far more knowledge about the company than any outsider is ever likely to possess.

It was to this end that the ASB published the Statement, *Operating and Financial Review*, in July 1993. This is not an accounting standard but a statement of best practice intended to encourage companies, particularly listed and large companies, to include an Operating and Financial Review as part of their annual report:

> **The Operating and Financial Review (OFR) is a framework for the directors to disclose and analyse the business's performance and the factors underlying its results and financial position, in order to assist users to assess for themselves the future potential of the business. (Para. 1)**

Such an Operating and Financial Review may be provided as a stand-alone document but may be included as part of another statement, such as the Chairman's or Chief Executive's Report. Experimentation is encouraged and many approaches have been seen in practice.[16] The Statement lists the essential features of the review and then provides more detailed guidance on its contents.

The essential features of the Operating and Financial Review are set out as follows (Para. 3):

- it should be written in a clear style and as succinctly as possible, to be readily understandable by the general reader of annual reports, and should include only matters that are likely to be significant to investors;
- it should be balanced and objective, dealing even-handedly with both good and bad aspects;
- it should refer to comments made in previous statements where these have not been borne out by events;
- it should contain analytical discussion rather than merely numerical analysis;
- it should follow a 'top-down' structure, discussing individual aspects of the business in the context of a discussion of the business as a whole;
- it should explain the reason for, and effect of, any changes in accounting policies;
- it should make it clear how any ratios or other numerical information given relate to the financial statements;
- it should include discussion of:
  - trends and factors underlying the business that have affected the results but are not expected to continue in the future; and
  - known events, trends and uncertainties that are expected to have an impact on the business in the future.

[16] See, for example, Pauline Weetman and Bill Collins, *Operating and Financial Review: Experiences and Exploration*, ICAS, Edinburgh, 1996.

The detailed guidance in the Statement is intended to help directors implement these general principles in writing their review. Not surprisingly, such matters of detail are classified under two headings, Operating Review and Financial Review respectively. The former includes discussion of the operating results, the profit for the year and other gains and losses reported in the Statement of Total Recognised Gains and Losses, a discussion of the dynamics of the business and of the investments which have been made for the future. Discussion of investment should deal with not just capital investment but also revenue investment, such as expenditure on advertising and marketing, training and both pure and applied research. Such revenue investment affects future periods as well as the current financial year.

The Financial Review should seek to explain the capital structure of the company, its treasury policy and the dynamics of its financial position. Thus it should discuss such matters as the types of capital instruments used and the maturity profiles of debt, the policies for managing interest rate risk and exchange rate risk, the pattern of borrowing requirements and resources of the business, such as brands and intangible assets, which are not reflected in the balance sheet.

The Statement recognises clearly that what is important to one company may not be important in the context of another company. It also recognises that, in deciding what should be disclosed, directors must weigh the benefits of disclosure against the possible danger of disclosing confidential or commercially sensitive information. Unfortunately, it is inevitable that some Boards of Directors will have difficulty in providing a review which is balanced and objective, dealing even-handedly with both good and bad aspects!

When it published its Statement in 1993, the ASB was of the view that the Operating and Financial Review was not a topic for regulation by an accounting standard but, rather, an area in which directors should be encouraged to follow the spirit of the Statement within the context of their own company. Given developments in narrative reporting since 1993, the ASB issued an exposure draft, *Revision of the the Statement 'Operating and Financial Review'* in June 2002. However the Operating and Financial Review has been given a much higher profile in the report of the Company Law Review Steering Group,[17] published in June 2001, and the subsequent White Paper, *Modernising Company Law*,[18] published in July 2002. We will deal with the proposals of the exposure draft and White Paper in turn.

Exposure draft

The exposure draft envisages that any Statement on the Operating and Financial Review will continue to be persuasive, rather than mandatory, and that it will continue to be addressed to directors of listed and large companies. While few changes to the information which should be disclosed and explained in the Review are proposed, the draft statement is structured somewhat differently from its predecessor. It is divided into two main sections. The first provides a list of the principles that directors should follow in preparing a Review and the second provides guidance on the structure and contents of the review.

The principles include such matters as the purpose of the statement, the intended audience, namely investors, the time-frame, the need for reliability and comparability and the need to explain any measures used in the Review. The guidance provides a framework for applying these principles under the headings shown in Table 17.1.

[17] *Modern Company Law for a Competitive Economy*, Final Report, June 2001.
[18] *Modernising Company Law*, Cm. 5553-I and 5553-II, HMSO, July 2002.

Table 17.1 The Exposure Draft Guidance on the OFR: Main headings

The business, its objectives and strategy

Operating Review
- Performance in the period
- Returns to shareholders
- Dynamics of the business
- Investment for the future

Financial Review
- Capital structure and treasury policy
- Cash flows
- Current liquidity
- Going concern

The exposure draft recognises that the list is not comprehensive and that not all headings will be appropriate to all companies. Like the present statement, the exposure draft encourages directors to focus on the matters which are relevant in the context of their own company. It also continues to accept that some of the information may be given in other parts of the annual report, such as the Chairman's Statement, rather than all being given in one standalone document. The adoption of such an approach may, of course, lead to difficulties in comparing the information provided by different companies in different parts of their annual reports.

The White Paper, *Modernising Company Law*

It is clear from the White Paper[19] that the Government now considers the Operating and Financial Review to be a major part of the annual reporting package providing users with an important narrative report on the company's business, performance and future plans. The Company Law Review, which preceded the White Paper, recommended that all Operating and Financial Reviews should include coverage of the following compulsory elements:

(i) the company's business and business objectives, strategy and principal drivers of performance;
(ii) a fair review of the development of the company's and/or group's business over the year and position at the end of it, including material post year-end events, operating performance and material changes; and
(iii) the dynamics of the business – i.e. known events, trends, uncertainties and other factors which may substantially affect future performance, including investment programmes.

However, it also proposed that the Review should include narrative discussion of other matters where the directors of the company consider them material and specifically provided examples of such matters as corporate governance, key relationships and environmental, community, social, ethical and reputational issues.

The Government now intends to introduce law requiring not just listed companies but some 1000 large companies and groups to prepare such a Review, although it intends to

[19] Cm. 5553-I and 5553-II, HMSO, July 2002.

devolve the making of detailed rules for the compilation of the Operating and Financial Review to the proposed new Standards Board.[20] Hence, for these companies, the publication of an Operating and Financial Review would, if the proposals are implemented, become mandatory, rather than just good practice.

It remains to be seen what form the proposed law will take and whether the ASB will issue a revised persuasive Statement or await the new legislation before issuing a new mandatory Statement or Standard.

The historical summary

It is usually difficult to draw conclusions about the performance and position of a company from a profit and loss account and balance sheet without some yardstick of comparison. Company law clearly recognises this in requiring the disclosure of corresponding amounts for the preceding financial year.[21] Thus the law ensures that, at a minimum, users are able to compare the performance and position in the current year with those of the previous year. Although such information is undoubtedly useful, comparative information for a longer period would be even more helpful in enabling users of financial statements to appreciate trends.

It was for this reason that, in the 1960s, the then Chairman of the Stock Exchange recommended that all listed companies should publish tables of relevant comparative figures for a ten-year period. Although this recommendation has never been incorporated into the Stock Exchange Regulations, nor into company law or accounting standards, it has become accepted practice for listed companies to provide a historical summary covering a five-year period. Five years has perhaps been chosen because this is the period specified for accountants' reports in prospectuses.

Given the lack of regulation, it is not surprising to find that the information included in a historical summary differs considerably from one company to another. While some companies only provide figures for turnover and profit for each of the five years, others provide summarised profit and loss accounts and balance sheets for the period. These are often supplemented by financial ratios, particularly earnings per share and dividend per share, and sometimes by a segmental analysis and/or non-financial information for the five-year period. Examples of the latter include the number of employees and the area of retail floor space available in each year. Readers familiar with the non-financial performance indicators published by utility companies will appreciate just how much detailed information of this type may be provided.

Given the lack of regulation and the fact that the historical summary is not subject to audit, it is, of course, possible for directors to choose to disclose those elements of a company's performance which show their company in the most favourable light. Thus, they may choose to disclose increasing amounts for turnover and operating profit while suppressing the fact that the profit before taxation and earnings per share may have been declining. It is for this reason that some accountants have called for regulation of the content of the historical summary.[22]

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[20] The Government proposals on the OFR are contained in Paras 4.28 to 4.41 of the White Paper and, for interested readers, Appendix D to that White Paper provides comments on a set of draft clauses on the Operating and Financial Review contained in Cm. 5553-II.

[21] Companies Act 1985, Schedule 4, Para. 4(1).

[22] See, for example, R.M. Wilkins and A.C. Lennard, 'Historical summaries', in *Financial Reporting 1987–88*, L.C.L. Skerratt and D.J. Tonkin (eds), ICAEW, London, 1988. Wilkins and Lennard suggested that the Stock Exchange should consider introducing a requirement for historical summaries and that this should be supplemented by a SORP, giving practical guidance on the detailed information to be included and how problems areas should be handled. No such developments have occurred.

In our view, the historical summary should include as a minimum the main headings and totals in the profit and loss account and balance sheet. Thus the profit and loss account disclosures would include:

- Turnover
- Operating profit
- Exceptional items
- Profit before taxation
- Profit after taxation
- Dividends paid and payable

These should be supplemented by ratios for earnings per share, dividends per share and dividend cover.

The balance sheet disclosures should include:

- Fixed assets
- Net current assets
- Borrowings
- Shareholders' interest

These should be supplemented by ratios for net assets per equity share.

In order to ensure comparability, in so far as this is possible, previously published figures should be adjusted to reflect changes in accounting policies and to correct any fundamental errors which have come to light. In addition, amounts shown for earnings per share, dividends per share and net assets per share should be adjusted to reflect any subsequent changes in the share capital such as bonus issues and rights issues. In order not to obscure trends, it is essential that exceptional items and indeed, any of those, now rare, extraordinary items should be disclosed separately. A brief description of these and of any major changes in the composition of the group should also be provided.

The main criticism we would make of published historical summaries is that the vast majority are not adjusted for inflation. Although many users are able to make approximate adjustments for changes in the value of money by use of the published Retail Price Index (RPI), the trend shown by unadjusted information may be misleading for less sophisticated users.

To illustrate, let us assume that a company has reported its turnover for a five-year period as shown in the first line of Table 17.2. On the basis of the reported figures, turnover has been growing consistently over the five-year period. However, the second line of the table provides values for the average RPI each year and the third line provides the turnover for each year measured in average pounds for 2000.[23]

Whereas the unadjusted figures show a steadily increasing turnover, once we adjust for the fact that the value of the pound has been falling, the 'real' turnover has fallen consistently throughout the five-year period.

The ASC recommended that such simple adjustments be made.[24] In our view it is quite indefensible for companies to publish five-year historical summaries without incorporating changes in the value of the pound. The need for such adjustments is, of course, greater the higher the rate of inflation.

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[23] To measure the turnover for each year in average pounds for 2000 – £(2000)s – it is merely necessary to multiply the turnover for each year by the average RPI for 2000 and to divide by the average RPI for the year to which the turnover relates. Hence the turnover for 1996 measured in £(2000)s, rounded to the nearest £1000, is calculated as £610 × 170.3/152.7 = £680. See Chapter 19 for a comprehensive coverage of the system of Current Purchasing Power (CPP) accounting, which attempts to adjust historical cost accounts for inflation, as measured by a general index such as the RPI.

[24] See the Discussion Paper, *Corresponding amounts and ten-year summaries in current cost accounting*, ASC, 1982, and the Handbook, *Accounting for the effects of changing prices*, ASC, 1986, Chapter 7.

Table 17.2 Company's turnover for five-year period

Year to 31 December	*1996*	*1997*	*1998*	*1999*	*2000*
Turnover (£000)	610	615	620	625	630
Average RPI for year	152.7	157.5	162.9	165.4	170.3
Turnover measured in £(2000) 000s	680	665	648	644	630

Reporting about and to employees

As we have seen in the introduction to this chapter, *The Corporate Report* favoured the expansion of the annual report to include an employment report.

Companies and other entities employ a large number of people who look to those entities for employment security and prospects while society at large expects employers to maintain certain standards of conduct in relation to their employees. *The Corporate Report* therefore took the view that significant economic entities should report employment information and recommended that the annual report should be expanded to include an employment report which should provide the following information:

(a) numbers employed, average for the financial year and actual on the first and last day;
(b) broad reasons for changes in the numbers employed;
(c) the age distribution and sex of employees;
(d) the functions of employees;
(e) the geographical location of major employment centres;
(f) major plant and site closures, disposals and acquisitions during the past year;
(g) the hours scheduled and worked by employees, giving as much detail as possible concerning differences between groups of employees;
(h) employment costs including fringe benefits;
(i) the costs and benefits associated with pension schemes and the ability of such schemes to meet future commitments;
(j) the cost and time spent on training;
(k) the names of unions recognised by the entity for the purpose of collective bargaining and membership figures where available or the fact that this information has not been made available by the unions concerned;
(l) information concerning safety and health including the frequency and severity of accidents and occupational diseases;
(m) selected ratios relating to employment.[25]

In the introduction to this chapter, we distinguished two types of statement.

The employment report envisaged by *The Corporate Report* is an example of what we called an 'extended' statement. It is a general-purpose statement to be included in the annual report of a company, which would provide much more information on employment than that required by company law. It should not be confused with another document, the employee report, which is an example of a 'rearranged and simplified' report, in this case a document separate from the annual report, intended for the use of employees.

[25] *The Corporate Report*, Para. 6.19. Appendix 3 to that document provides an example of the sort of employment report envisaged.

Employee reports usually contain a simplified set of accounts together with a narrative review of those accounts. The emphasis is on making the information as easy to understand as possible and such reports try to avoid technical language and frequently include charts and diagrams which might show, for example, the changes in sales or profits over a number of years or the distribution of value added between the team members.

In large companies the employees are primarily interested in a part, rather than the whole, of the entity and frequently employee reports are used to give more detailed segmental information about geographical areas, divisions or plants. They can thus be tailor-made for the particular company and can be improved in response to suggestions from the users, that is the employees, themselves.

Perhaps not surprisingly, companies have been reluctant to publish employment reports, especially given the fact that there has been little published work explaining which users find the particular pieces of information useful and for what purposes they may be useful. On the other hand, employee reports are more widely used and these are often also issued to shareholders as a matter of course.

Summary financial statements

As we were reminded in Chapter 2, company law has long required limited companies to send copies of their annual accounts, directors' reports and auditors' reports to every member and debenture holder of the company. However, the Companies Act 1989 introduced new provisions whereby a *listed* company may instead send members a summary financial statement.[26] Such a statement must explain that it is a summary of the full financial statements, inform members that they are entitled to those full financial statements and carry a warning that the summary financial statement does not contain sufficient information to permit a full understanding of the results or position of the company or group. It must contain a report by the auditor that the statement is consistent with the full financial statements and that it complies with the law. It must also include any qualified auditor's report together with details of certain types of qualification.

While the Companies Act 1989 introduced these general principles, the detailed regulations have been introduced by statutory instrument.[27] This specified the minimum content of the summary financial statement which comprises certain information from the directors' report and the main headings and associated amounts from the profit and loss account and balance sheet.

With regard to the information from the directors' report, it is necessary to disclose the names of all directors who served during the financial year and to present either the whole, or a summary, of the fair review of results and position. Information about post-balance sheet events and likely future developments must also be included. The minimum contents of the summary profit and loss account are set out in Table 17.3. Given that almost all listed companies prepare group accounts, the table is that which is applicable to consolidated financial statements.

As may be seen from Table 17.3, the summary financial statement is indeed a highly simplified statement and, as the required warning states, it is unlikely to contain sufficient information to allow for a full understanding of the group's performance and position.

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[26] Companies Act 1985, s. 251.

[27] The Companies (Summary Financial Statement) Regulations 1990, SI 1990/515.

However, given the increasing complexity of the main financial statements, such summary financial statements certainly have a role to play and have the added advantage that they reduce substantially the cost to listed companies of sending full financial statements to all shareholders.

Table 17.3 Minimum content of summary profit and loss account and balance sheet

Summary consolidated profit and loss account

	£
Turnover	x
Income from shares in associated undertakings	x
Other interest receivable and similar income less interest payable and similar charges	x
Profit (or loss) on ordinary activities before taxation	x
Tax on profit (or loss) on ordinary activities	x
Profit (or loss) on ordinary activities after tax	x
Minority interests	x
	x
Extraordinary items (if any)	x
Profit (or loss) for the financial year	x
Dividends paid and proposed	x
	x
Directors' emoluments (total only)	x

Summary consolidated balance sheet

	£	£
Fixed assets		x
Current assets	x	
Creditors: amounts falling due within one year	x	
Net current assets		x
Total assets less current liabilities		x
Creditors: amounts falling due after more than one year		x
		x
Provisions for liabilities and charges		x
		x
Capital and reserves		x
Minority interests		x
		x

The Government is so persuaded of the merits of the summary financial statement that the White Paper, *Modernising Company Law*, contains a proposal that all companies should be able to provide their shareholders with a simplified summary statement, with wider coverage than just a summary financial statement, of the annual reporting documents. Thus all

companies, not just listed companies, would be able to draw up and circulate such a statement to their shareholders although such shareholders would retain the right to receive the full documents if they so wish. The Government proposes to delegate the making of rules on the form and content of the summary statement to the proposed Standards Board.[28]

Interim reports and preliminary announcements

So far in this chapter, we have concentrated on the annual reports of companies and their growth in size over the years. However, no matter how much information and how many statements are provided in such reports, annual reporting is unlikely to provide sufficient information for investors to make satisfactory investment decisions. More timely information is needed and it is to this end that the London Stock Exchange requires listed companies to publish half-yearly, that is interim, reports as well as preliminary announcements of the full year's results as soon as this is possible.

The Stock Exchange rules on the contents of these documents are rather rudimentary and the ASB has issued two non-mandatory Statements to provide guidance on best practice in these areas: 'Interim Reports' was issued in September 1997 while 'Preliminary Announcements' was issued in July 1998.

Interim reports

In order to ensure that the information is timely, the Statement encourages companies to make their interim reports available within 60 days of the end of the period. In the UK the interim period is a half year while in other countries, such as the USA, the reporting period is a quarter.

The purpose of the interim report is to provide an update to the previous annual report and the Statement recommends that it include the following:

- **Management commentary**.
- **Summarised profit and loss account**, including the analysis of turnover and operating profit required by FRS 3, and accompanied by segmental information and one or more earnings per share figures.
- **Statement of total recognised gains and losses**, where material gains or losses, other than profit for the period, are recognised.
- **Summarised balance sheet**.
- **Summarised cash flow statement**, providing a summary of cash flows using the nine headings required by FRS 1 and supported by the two notes required by that standard.

The management commentary should be a less comprehensive version of the Operating and Financial Review, discussed earlier in this chapter. It should highlight and explain what has happened since the previous annual report and is intended to help users to understand what has happened and to make judgements on what is likely to happen in future. The interim report will therefore provide both confirmatory and predictive information.

The Statement provides a list of the information which should be included in the summarised financial statements and Table 17.4 provides this listing for a consolidated profit and loss account and balance sheet. Comparative amounts are required.

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[28] *Modernising Company Law*, Cm. 5553-I, Para. 4.43.

Table 17.4 Interim Report: Contents of summarised consolidated profit and loss account and balance sheet

Summarised consolidated profit and loss account

- Turnover
- Operating profit or loss
- Interest payable less interest receivable (net)
- Profit or loss on ordinary activities before tax
- Tax on profit or loss on ordinary activities
- Profit or loss on ordinary activities after tax
- Minority interests
- Profit or loss for the period
- Dividends paid and proposed

Summarised consolidated balance sheet

- Fixed assets
- Current assets
  - Stocks
  - Debtors
  - Cash at bank and in hand
  - Other current assets
- Creditors: amounts falling due within one year
- Net current assets (liabilities)
- Total assets less current liabilities
- Creditors: amounts falling due after more than one year
- Provisions for liabilities and charges
- Capital and reserves
- Minority interests

Note: Turnover and operating profit should be analysed as required by FRS 3 and there should be a separate identification of amounts relating to associates and joint ventures.

The interim financial statements should normally be drawn up using the same accounting policies as those in the previous annual financial statements. The exception would be when it is intended to change these policies in the next annual financial statements, in which case the new policies should be implemented in the interim statements and an explanation of the change should be provided.

For the accountant involved with such an interim report, two different approaches could be adopted in preparing the financial statements. The first, the discrete method, regards the half-year as a distinct reporting period. The second, the integral method, regards the half-year as merely a part of the longer annual reporting period. The ASB Statement recommends the use of the discrete method. This has the conceptual advantage that the elements included in the interim financial statements may be defined in the same way as they are for the annual financial statements. However, it also recognises that this approach will not be appropriate for all items of revenue and expense and specifically draws attention to taxation as one such expense. The calculation of the corporation tax expense for a separate half-year period

would often produce a meaningless figure. In such a case, it would be necessary to estimate the corporation tax payable for the full year and to apportion the relevant amount to the half-year period. In practice, the preparation of the half-yearly financial statements will inevitably involve a compromise between the use of both the discrete method and the integral method.

Preliminary announcements

In the UK, listed companies are required to notify the Stock Exchange of their preliminary statement of annual results and dividends as soon as possible after these are approved by the Board of Directors. At present these preliminary announcements are also distributed to financial analysts and institutional investors, rather than to shareholders at large. The ASB Statement, 'Preliminary Announcements', encourages companies to distribute them more widely and, in particular, encourages companies to experiment with the use of electronic communication to achieve this end.

As with interim reports, the Stock Exchange requirements are minimal and rather out of date, so the ASB Statement is intended to lay down best practice in this area.

Given that both interim reports and preliminary announcements are providing new information to the market about the company's performance and position, it is not surprising that there is considerable overlap between the contents of the two statements. Thus the Statement recommends that the preliminary announcement include the same documents as the interim report, namely:

- Management commentary
- Summarised profit and loss account
- Statement of total recognised gains and losses
- Summarised balance sheet
- Summarised cash flow statement

The management commentary should provide a balanced coverage of developments since the last annual report and interim report. The ASB encourages directors to refer specifically to developments in the second half of the year, which might otherwise not be commented upon.

The contents of the summary financial statements should be the same as those in the interim report as discussed in the previous section and partially listed in Table 17.4.

A preliminary announcement can only be made once the preparation and audit of the, as yet unpublished, financial statements for the year are well advanced; approval of the preliminary statement of results by the Board and agreement of the auditors are required before publication. It follows that the preparation of the preliminary announcement for the year avoids many of the conceptual problems of preparing an interim report.

The Government is determined to speed up the publication of results by companies, especially listed companies. We have seen, in Chapter 2, how the White Paper, *Modernising Company Law,* has proposed a shortening of the time limits in which companies must file their financial statements with the Registrar of Companies. That White Paper also proposes the introduction of legislation to require listed companies to publish any preliminary announcement, as well as their annual reporting documents, on the Internet. It envisages a requirement that the annual reporting documents should be available on the Internet within four months of the end of the company's year end.[29]

[29] *Modernising Company Law*, Cm. 5553-I, Paras 4.50–4.51.

Summary

In this chapter, we have examined a number of documents that are frequently included in a company's annual reporting package, even though they are not at present required by UK company law.

The first and largest part of the chapter is devoted to the Cash Flow Statement, a primary financial statement required by both FRS 1 (1996) and IAS 7 (1993) and, probably, soon to be required by company law. We explain how to prepare a Cash Flow Statement using the nine headings required by FRS 1 and illustrate this for an independent company. We then explore the preparation of such a statement for a group and look at the treatment of acquisitions and disposals of subsidiaries as well as the impact that associates, joint ventures and foreign currencies have on the statement. We explain the major differences between FRS 1 and IAS 7, differences that are likely to cause considerable problems for the convergence programme.

We then turn to the Operating and Financial Review (OFR), which the ASB (in its Statement issued in 1993) encouraged listed companies to prepare. We explore the purposes of such a narrative statement and illustrate its content before examining the changes proposed by the exposure draft for a Revised Statement and by the Government White Paper, *Modernising Company Law*. The latter proposes to raise the status of this OFR by the introduction of a legislative requirement for some 1000 large companies or groups to publish such a review.

We then look more briefly at three topics, the Historical summary, Reporting about and to employees and the Summary financial statement. We outline the reasons for the publication of historical summaries and discuss their content. We point out that, in our view, it is indefensible that companies consistently publish five-year historical summaries without making adjustments for inflation. We distinguish between relatively rare Employment reports, which we classify as 'extended statements', and the simplified reports for employees, which are sometimes sent to shareholders as well. We explain that, although the law at present allows listed companies to provide their shareholders with a summary financial statement, the White Paper proposes that all companies should be able to publish a simplified summary statement subject to the right of shareholders to receive the full annual reporting package if they so desire.

Finally we examine the ASB's attempts to encourage and improve the reporting of interim results and preliminary announcements. We end by drawing attention to the proposal in the White Paper that all listed companies should publish, not only their preliminary announcements, but also their complete annual reporting documents on the Internet within four months of their year ends.

Recommended reading

Accounting Standards Steering Committee, *The Corporate Report*, London, 1975.

L.C. Heath and P. Rosenfield, 'Solvency: the forgotten half of financial reporting', in R. Bloom and P.T. Elgers (eds), *Accounting Theory and Policy: A Reader*, 2nd edn, Harcourt Brace Jovanovich, Orlando, 1987.

P. Weetman and B. Collins, *Operating and Financial Review: Experience and Exploration*, ICAS, Edinburgh, 1996.

Readers are also referred to the latest edition of *UK & International GAAP*, Ernst & Young, which provides much greater detailed coverage of this and other topics in this book. At the time of writing, the most recent edition is the 7th, A. Wilson, M. Davies, M. Curtis and G. Wilkinson-Riddle (eds), Butterworths Tolley, London, 2001. The relevant chapters are 29, 'Cash flow statements', 4, 'Corporate governance' and 33, 'Interim reports and preliminary announcements'.

A useful website

www.dti.gov.uk/companiesbill

Questions

17.1 In November 1996 the Accounting Standards Board issued FRS 1 (Revised) – *Cash Flow Statements*. The appendix to FRS 1 contains a number of examples of cash flow statements drawn up in accordance with the new Standard. The examples given present the cash flows under a number of standard headings, as shown below.

		£000
(i)	Cash flow from operating activities	X
(ii)	Returns on investments and servicing of finance	X
(iii)	Taxation	X
(iv)	Capital expenditure and financial investment	X
(v)	Acquisitions and disposals	X
(vi)	Equity dividends paid	X
		X
(vii)	Management of liquid resources	X
(viii)	Financing	X
	Decrease in cash in the period	X

Requirements

(a) **Describe the cash flows which are reported under each of the headings (i) to (viii), given above.** (10 marks)

(b) **Summarise the changes which FRS 1 (Revised) made to the old FRS 1, and explain why each change was considered necessary by the Accounting Standards Board.** (10 marks)

CIMA, Financial Reporting, November 1997 **(20 marks)**

17.2 The following information has been extracted from the draft financial statements of T plc:

T plc
Profit and loss account for the year ended 30 September 2001

	£000
Sales	15 000
Cost of sales	(9 000)
	6 000
Other operating expenses	(2 400)
	3 600
Interest	(24)
Profit before taxation	3 576
Taxation	(1 040)
Dividends	(1 100)
	1 436
Balance brought forward	4 400
	5 836

T plc
Balance sheets at 30 September

	2001		*2000*	
	£000	£000	£000	£000
Fixed assets		18 160		14 500
Current assets:				
Stock	1 600		1 100	
Debtors	1 500		800	
Bank	150		1 200	
	3 250		3 100	
Current liabilities:				
Creditors	(700)		(800)	
Proposed dividend	(700)		(600)	
Taxation	(1 040)		(685)	
	(2 440)		(2 085)	
Net current assets		810		1 015
		18 970		15 515
Long-term loans		(1 700)		(2 900)
		17 270		12 615
Deferred tax		(600)		(400)
		16 670		12 215
Ordinary share capital		2 500		2 000
Share premium		8 334		5 815
Profit and loss		5 836		4 400
		16 670		12 215

Fixed assets

	Land and buildings	*Plant and machinery*	*Total*
	£000	£000	£000
Cost			
30 September 2000	8 400	10 800	19 200
Additions	2 800	5 200	8 000
Disposals	–	(2 600)	(2 600)
30 September 2001	11 200	13 400	24 600
Depreciation			
30 September 2000	1 300	3 400	4 700
Disposals	–	(900)	(900)
Charge for year	240	2 400	2 640
30 September 2001	1 540	4 900	6 440
Net book value			
30 September 2001	9 660	8 500	18 160
30 September 2000	7 100	7 400	14 500

The plant and machinery that was disposed of during the year was sold for £730 000.

Required

(a) **Prepare T plc's cash flow statement and associated notes for the year ended 30 September 2001. These should be in a form suitable for publication.** (15 marks)

After the publication of the balance sheet at 30 September 2000, the directors of T plc were criticised for holding too much cash. The annual report for the year ended 30 September 2001 claims that the company has managed its cash more effectively.

Required

(b) **Explain whether T plc's cash management appears to have been any more effective this year.** (5 marks)

CIMA, Financial Accounting – UK Accounting Standards, November 2001 **(20 marks)**

17.3 Inverness plc has prepared the following draft financial statements for the year ended 31 October 1997:

Balance sheet as on 31 October 1997

	1997		*1996*	
	£000	£000	£000	£000
Fixed assets				
Freehold property – at cost/valuation	31 000		28 000	
– accumulated depreciation	–		(7 200)	
		31 000		20 800
Plant and machinery – at cost	20 000		16 400	
– accumulated depreciation	(8 600)		(5 400)	
		11 400		11 000
c/f		42 400		31 800

Balance sheet as on 31 October 1997 (continued)

	1997		*1996*	
	£000	£000	£000	£000
b/f		42 400		31 800
Current assets				
Stock	7 200		5 600	
Trade debtors	4 800		5 200	
ACT recoverable	475		550	
Investments	2 000		1 600	
Cash at bank and in hand	3 000		1 400	
	17 475		14 350	
Creditors: amounts falling due within one year				
Trade creditors	(5 200)		(3 700)	
Corporation tax	(2 000)		(3 700)	
ACT payable	(475)		(550)	
Proposed dividends	(1 900)		(2 200)	
	(9 575)		(10 150)	
Net current assets		7 900		4 200
		50 300		36 000
Creditors: amounts falling due after more than one year				
Debentures		(7 000)		(2 000)
		43 300		34 000
Share capital		25 000		24 000
Share premium		4 600		3 900
Revalution reserve		9 000		–
Profit and loss account		4 700		6 100
		43 300		34 000

Profit and loss account for the year ended 31 October 1997

	£000	£000
Turnover		34 200
Change in stocks of finished goods and work in progress		(6 600)
Own work capitalised		500
Raw materials and consumables		(14 000)
Staff costs		(5 200)
Depreciation – freehold property	(800)	
– plant and machinery	(4 000)	
		(4 800)
Loss on sale of fixed assets		(600)
Interest receivable		500
Interest payable		(1 000)
Profit on ordinary activities before taxation		3 000
Taxation		(2 500)
Profit on ordinary activities after taxation		500
Dividends proposed		(1 900)
		(1 400)

Additional information

(1) During the year an item of plant and machinery with a cost of £1.9 million was sold.

(2) The freehold property was revalued on 31 October 1997.

(3) Interest of £400 000 was capitalised during the year as part of additions to freehold property.

Requirements

(a) **Prepare a cash flow statement and related notes for Inverness plc for the year ended 31 October 1997 in accordance with FRS 1 (Revised), *Cash flow statements*.** (13 marks)

(b) **Briefly explain the main reasons for the recent changes to FRS 1.** (4 marks)

[*Authors' note*: ACT recoverable and ACT payable refer to Advance Corporation Tax, which has been abolished. The current asset is equal to the current liability so both may be ignored in working this question.]

ICAEW, Financial Reporting, November 1997 **(17 marks)**

17.4 You are the management accountant of Holmes plc and you are in the process of preparing the consolidated cash flow statement. Your Managing Director is aware that the statement is required by FRS 1 – *Cash flow statements*, and that a number of notes to the statement must also be included. She has a reasonable understanding of the rationale behind the cash flow statement but is not clear as to why so many notes to the statement are required.

Requirements

(a) **Prepare the consolidated cash flow statement of the Holmes group for the year ended 30 September 1999 in the form required by FRS 1 – *Cash flow statements*.**
Show your workings clearly.
Do not prepare notes to the cash flow statement. (30 marks)

(b) **Write a memorandum to your Managing Director which explains the need for the following notes to the cash flow statement:**
- **reconciliation of operating profit to operating cash flows;**
- **reconciliation of net cash flow to movement in net debt;**
- **summary of the effect of the acquisition of Watson plc.**

Do not prepare any of these three notes for Holmes plc. (8 marks)

(38 marks)

Extracts from the consolidated financial statements of Holmes plc are given overleaf:

Consolidated profit and loss accounts for the year ended	*30 September 1999*		*30 September 1998*	
	£ million	£ million	£ million	£ million
Turnover		600		500
Cost of sales		(300)		(240)
Gross profit		300		260
Other operating expenses (*Note 1*)		(150)		(130)
Group operating profit		150		130
Share of operating profit of associates		40		35
Interest payable:				
– group	50		45	
– associates	15		10	
		(65)		(55)
Profit before exceptional item		125		110
Exceptional item (*Note 2*)		10		–
Profit before taxation		135		110
Taxation:				
– group	35		25	
– associates	8	(43)	8	(33)
Profit after taxation		92		77
Minority interests		(10)		(6)
Group profit		82		71
Equity dividends		(25)		(25)
Retained profit for year		57		46

Consolidated balance sheets at	*30 September 1999*		*30 September 1998*	
	£ million	£ million	£ million	£ million
Fixed assets				
Intangible assets (*Note 3*)	25		19	
Tangible assets (*Note 4*)	240		280	
Investments in associates	80		70	
		345		369
Current assets				
Stocks	105		90	
Debtors	120		100	
Investments	20		70	
Cash in hand	10		5	
	255		265	
Creditors falling due within one year				
Trade creditors (*Note 5*)	40		30	
Taxation	10		8	
Proposed dividends	25		25	
Obligations under finance leases	25		20	
Other creditors (*Note 6*)	6		5	
Bank overdraft	20		80	
	126		168	
c/f	129	345	97	369

Consolidated balance sheets at	*30 September 1999*		*30 September 1998*	
	£ million	£ million	£ million	£ million
b/f	129	345	97	369
Net current assets		129		97
		474		466
Creditors falling due after more than one year				
Obligations under finance leases		(80)		(70)
12% loan stock		–		(90)
Provisions for liabilities and charges				
Deferred taxation		(30)		(24)
Minority interests		(65)		(40)
		299		242
Capital and reserves				
Called-up share capital		100		100
Revaluation reserve		–		20
Profit and loss account		199		122
		299		242

Notes to the financial statements:

Note 1 – other operating expenses

	1999	*1998*
	£ million	£ million
Distribution costs	81	75
Administrative expenses	75	70
Investment income	(6)	(15)
	150	130

From time to time, the group invests cash surpluses in listed securities which are shown as current asset investments in the consolidated balance sheet.

Note 2 – exceptional item

This represents the gain on sale of a large freehold property sold by Holmes plc on 1 October 1998 and leased back on an operating lease in line with the practice adopted by the rest of the group. The property was not depreciated in the current year. The property had been revalued in 1990 and the revaluation surplus credited to a revaluation reserve. No other entries had been made in the revaluation reserve prior to the sale of the property.

Note 3 – intangible fixed assets

This comprises the unamortised balance of goodwill on consolidation which is written off over its useful economic life. During the year ended 30 September 1999, Holmes plc purchased 80% of the issued equity share capital of Watson plc for £100 million payable in cash. The net assets of Watson plc at the date of acquisition were assessed as having fair values as follows:

	£ million
Plant and machinery – owned	50
Fixture and fittings – owned	10
Stocks	30
Debtors	25
Cash at bank and in hand	10
Trade creditors	(15)
Taxation	(5)
	105

The goodwill arising was assessed as having a useful economic life of 16 years and a full year's write-off was made in the year ended 30 September 1999. Apart from the acquisition of Watson plc, there were no other changes to the group structure in the year.

Note 4 – tangible fixed assets

	30 September 1999	*30 September 1998*
	£ million	£ million
Freehold land and buildings	–	90
Plant and machinery – owned	130	100
Plant and machinery – leased	90	70
Fixtures and fittings – owned	20	20
	240	280

During the year the group entered into new finance lease agreements in respect of some items of plant and machinery. The amounts debited to fixed assets in respect of such agreements during the year totalled £40 million. No disposals of plant and machinery (owned or leased) or fixtures and fittings took place during the year. Depreciation of tangible fixed assets for the year totalled £58 million.

Note 5 – trade creditors
Trade creditors at 30 September 1999 and 30 September 1998 do not include any accrued interest.

Note 6 – other creditors
These comprise dividends payable to minority shareholders.

CIMA, Financial Reporting, November 1999

17.5 The following draft financial statements relate to the Duke Group plc:

Draft Group Balance Sheet at 31 May 2000

	2000	*1999*
	£m	£m
Fixed Assets:		
Intangible assets – goodwill	90	83
Tangible assets	1239	1010
Investments	780	270
	2109	1363
Current Assets:		
Stocks	750	588
Debtors	660	530
Cash at bank and in hand	45	140
	1455	1258
Creditors: amounts falling due within one year	(1501)	(1213)
Net Current Assets	(46)	45
Total assets less current liabilities	2063	1408
Creditors: amounts falling due after more than one year	(1262)	(930)
Minority interests – equity	(250)	(150)
	551	328

Draft Group Balance Sheet at 31 May 2000

	2000	*1999*
	£m	£m
Capital and Reserves:		
Called up share capital:		
– ordinary shares of £1	100	70
– 7% redeemable preference shares of £1 each	136	130
Share premium account	85	15
Revaluation reserve	30	10
Profit and loss account	200	103
	551	328

Draft Group Profit and Loss Account for the year ended 31 May 2000

	£m	£m
Turnover– continuing operations	5795	
– acquisitions	1515	
		7310
Cost of sales		(5920)
Gross profit		1390
Distribution and administrative expenses		(772)
Share of operating profit in associate		98
Operating profit– continuing operations	598	
– acquisitions	118	716
Profit on sale of tangible fixed assets		15
Interest receivable	34	
Interest payable	(22)	
		12
Profit on ordinary activities before taxation		743
Tax on profit on ordinary activities		(213)
(including tax on income from associated undertakings £15 million)		
Profit on ordinary activities after taxation		530
Minority interests – equity		(97)
Profit attributable to members of the parent company		433
Dividends	135	
Other non-equity appropriations	6	(141)
Retained profit for the year		292

Group Statement of Total Recognised Gains and Losses for the year ended 31 May 2000

	£m
Profit attributable to members of the parent company	433
Surplus on revaluation of fixed assets	20
Exchange difference on retranslation of foreign equity investment	(205)
Exchange difference on loan to finance foreign equity investment	10
	258

Reconciliation of Shareholders' Funds for the year ended 31 May 2000

Total recognised gains and losses	258
Dividends	(135)
Other movements:	
New shares issued	100
Total movements during the year	223
Shareholders funds at 1 June 1999	328
Shareholders funds at 31 May 2000	551

The following information is relevant to the Duke Group plc:

(i) Duke acquired an eighty per cent holding in Regent plc on 1 June 1999. The fair values of the assets of Regent on 1 June 1999 were as follows:

	£m
Tangible fixed assets	60
Stocks	30
Debtors	25
Cash at bank and in hand	35
Trade Creditors	(20)
Corporation Tax	(30)
	100

The purchase consideration was £97 million and comprised 20 million ordinary shares of £1 in Duke, valued at £4, and £17 million in cash. The group amortises goodwill over ten years.

(ii) The tangible fixed asset movement for the period comprised the following amounts at net book value:

	£m
Balance at 1 June 1999	1010
Additions (including Regent)	278
Revaluations of properties	20
Disposals	(30)
Depreciation	(39)
Balance at 31 May 2000	1239

(iii) There have been no sales of fixed asset investments in the year. The investments included under fixed assets comprised the following items:

	£m *2000*	£m *1999*
Investment in associated company	300	220
Trade investment (including purchase of foreign equity investment of £400m equivalent during year to 31 May 2000)	480	50
	780	270

(iv) Interest receivable included in debtors was £15m as at 31 May 1999 and £17m as at 31 May 2000.

(v) Creditors: amounts falling due within one year comprised the following items:

	£m *2000*	£m *1999*
Trade creditors (including interest payable £9m (2000) Nil (1999))	1193	913
Corporation tax	203	200
Dividends	105	100
	1501	1213

(vi) Duke had allotted 10 million ordinary shares of £1 at a price of £2 upon the exercise of directors' options during the year.

(vii) Included in creditors: amounts payable after more than one year is a bill of exchange for £100 million (raised 30 June 1999) which was given to a supplier on the purchase of fixed assets and which is payable on 1 July 2001.

(viii) The exchange differences included in the Statement of Total Recognised Gains and Losses relate to a transaction involving a foreign equity investment. A loan of £300 million was taken out during the year to finance a foreign equity investment in Peer of £400 million. Both amounts are after retranslation at 31 May 2000.

(ix) The preference share dividends are always paid in full on 1 July each year and at 31 May 2000 the preference shares have a par value of £130 million.

Required

(a) **Prepare a group cash flow statement using the indirect method for the Duke Group plc for the year ended 31 May 2000 in accordance with the requirements of FRS 1 (Revised), *Cash Flow Statements.***

Your answer should include the following:
(i) **a reconciliation of operating profit to operating cash flows;**
(ii) **an analysis of cash flows for any headings netted in the cash flow statement.**

The notes regarding the acquisition of the subsidiary and a reconciliation of net cash flow to movement in net debt are not required. (24 marks)

(b) **Discuss the nature of the additional information which is provided by the Group Cash Flow Statement of the Duke group in (a) above as compared to the Group Profit and Loss Account and Group Balance Sheet of Duke.** (6 marks)

ACCA, Financial Reporting Environment (UK Stream), June 2000 **(30 marks)**

17.6 You are the Consolidation Accountant of Worldwide plc, a UK company with subsidiaries located throughout the world. You are currently involved in preparing the consolidated financial statements for the year ended 30 September 2002. Your assistant has prepared the consolidated profit and loss account, the consolidated statement of total recognised gains and losses, the consolidated balance sheet and some supporting schedules. The material your assistant has prepared is given overleaf.

Worldwide plc – consolidated profit and loss account for the year ended 30 September 2002

	£ million
Turnover	4000
Cost of sales	(2200)
Gross profit	1800
Other operating expenses	(800)
Operating profit	1000
Gain on sale of subsidiary (*Note 1*)	58
Interest payable (*Note 2*)	(200)
Profit before taxation	858
Taxation	(180)
Profit after taxation	678
Minority interests	(128)
Group profit	550
Dividends paid:	
– preference shares	(40)
– ordinary shares	(200)
Retained profit	310

Worldwide plc – consolidated statement of total recognised gains and losses for the year ended 30 September 2002

	£ million
Group profit for the period	550
Exchange differences (Note 3)	47
Total gains and losses for the period	597

Worldwide plc – consolidated balance sheets at 30 September

	2002		*2001*	
	£ million	£ million	£ million	£ million
Fixed assets:				
Goodwill on consolidation	42		65	
Tangible assets (*Note 4*)	5900		4100	
		5942		4165
Current assets:				
Stocks	950		800	
Trade debtors	1000		900	
Short-term investments	60		80	
Cash	20		18	
	2030		1798	
Creditors: amounts falling due within one year:				
Trade creditors	450		400	
Accrued interest	25		20	
Taxation	130		120	
Obligations under finance leases	45		25	
Bank overdrafts	65		40	
	715		605	
c/f	1315	5942	1193	4165

Worldwide plc – consolidated balance sheets at 30 September (continued)

	2002		*2001*	
	£ million	£ million	£ million	£ million
b/f	1315	5942	1193	4165
Net current assets		1315		1193
Total assets less current liabilities		7257		5358
Creditors: amounts falling due after more than one year:				
Obligations under finance leases	225		140	
Long-term loans	1554		1200	
		(1779)		(1340)
Provisions for liabilities and charges:				
Deferred taxation		(278)		(218)
		5200		3800
Capital and reserves:				
Ordinary share capital		2500		2000
8% preference share capital		500		500
Share premium account		500		–
Profit and loss account		1157		800
		4657		3300
Minority interests		543		500
		5200		3800

Note 1 – gain on sale of subsidiary

On 1 April 2002, Worldwide plc disposed of a 75%-owned subsidiary incorporated in the UK for £250 million in cash. The balance sheet of the subsidiary drawn up at the date of disposal showed the following:

	£ million
Tangible fixed assets	200
Stock	100
Trade debtors	110
Cash	10
Trade creditors	(80)
Taxation payable	(25)
Long-term loan	(75)
	240

This subsidiary had been acquired on 1 April 1994 for a cash payment of £110 million when its net assets had a fair value of £120 million. Goodwill on consolidation is amortised on a monthly basis over 20 years.

Note 2 – interest payable

During the year, the group constructed a factory in the UK. Construction commenced on 1 November 2001 and the factory was ready for use on 1 June 2002. However, production did not begin at the factory until 1 August 2002. The construction of the factory was financed by general borrowings denominated in £s. Your assistant has included the interest relating to the period from 1 November 2001 to 1 June 2002 in the cost of tangible fixed

assets rather than taking it to the profit and loss account. The amount of interest that was treated in this way is £10 million. The figure was arrived at by applying a relevant capitalisation rate to expenditure on the factory in the period 1 November 2001 to 1 June 2002.

Note 3 – exchange differences

	Total £ million	*Group share* £ million
Arising on retranslation of opening net assets:		
Tangible fixed assets	25	20
Stock	20	15
Debtors	20	16
Trade creditors	(9)	(6)
	56	45
Arising on retranslation of profit for the period	16	12
Offset of exchange loss on Worldwide plc loans (see below)	(10)	(10)
	62	47

Worldwide plc has taken out a number of long-term loans denominated in foreign currencies to partly finance the equity investments in its foreign subsidiaries. Your assistant has offset the exchange differences arising on the retranslation of these loans against the exchange differences arising on the retranslation of the net investments in the relevant subsidiaries. The exchange gain on retranslation of the profit and loss account (from average rate for the year to the closing rate) relates to operating profit excluding depreciation.

Note 4 – tangible fixed assets

- During the period, the depreciation charged in the consolidated profit and loss account was £320 million.
- Apart from the disposal mentioned in note 1, the group disposed of tangible fixed assets having a net book value of £190 million for cash proceeds of £198 million.
- During the period, the group entered into a significant number of new finance leases. Additions to tangible fixed assets include £250 million capitalised under finance leases.

Required:

(a) **Prepare the consolidated cash flow statement of the Worldwide plc group for the year ended 30 September 2002.** ***You should use the indirect method.*** **Notes to the cash flow statement are NOT required.** (30 marks)

(b) **Evaluate the extent to which the accounting treatment for capitalising interest described in** ***note 2*** **above is in accordance with existing Accounting Standards.** (5 marks)

(c) **Evaluate the extent to which the accounting treatment of exchange differences described in** ***note 3*** **above is in accordance with existing Accounting Standards. Your answer should refer to any relevant current developments that have the potential to affect your evaluation.** (5 marks)

Note: Your evaluations for requirements (b) and (c) should not change your answer to requirement (a) of this question.

CIMA, Financial Reporting – UK Accounting Standards, November 2002 **(40 marks)**

17.7 Portal Group, a public limited company, has prepared the following group cash flow statement for the year ended 31 December 2000:

Portal Group plc
Group Statement of cash flows for the year ended 31 December 2000 (draft)

	£m	£m
Net cash inflow from operating activities		875
Returns on investments and servicing of finance		
Interest received	26	
Interest paid	(9)	
Minority interest	(40)	(23)
Taxation		31
Capital expenditure		
Purchase of tangible fixed assets	(380)	
Disposals and transfers of fixed assets at carrying value	1585	1205
Acquisitions and disposals		
Disposal of subsidiary	(25)	
Purchase of interest in joint venture	(225)	(250)
Net cash inflow before use of management of liquid resources and financing		1838
Management of liquid resources		
Decrease in short term deposits		(143)
Increase in cash in the period		1695

The accountant has asked your advice on certain technical matters relating to the preparation of the group cash flow statement. Additionally the accountant has asked you to prepare a presentation for the directors on the usefulness and meaning of cash flow statements generally and specifically on the group cash flow statement of Portal.

The accountant has informed you that the actual change in the cash balance for the period is £165 million, which does not reconcile with the figure in the draft group cash flow statement above of £1695 million.

The accountant feels that the reasons for the difference are the incorrect treatment of several elements of the cash flow statement of which he has little technical knowledge. The following information relates to these elements:

(a) Portal has disposed of a subsidiary company, Web plc, during the year. At the date of disposal (1 June 2000) the following balance sheet was prepared for Web plc:

		£m	£m
Tangible fixed assets	– valuation		340
	– depreciation		(30)
			310
Stocks		60	
Debtors		50	
Cash at bank and in hand		130	
		240	
Creditors: amounts falling due within one year (including taxation £25 million)		(130)	110
			420
Called up share capital			100
Profit and loss account			320
			420

The loss on the sale of the subsidiary in the group accounts comprised:

	£m
Sale proceeds – ordinary shares	300
– cash	75
	375
Net assets sold (80% of 420)	(336)
Goodwill	(64)
Loss on sale	(25)

The accountant was unsure as to how to deal with the above disposal and has simply included the above loss in the cash flow statement without any further adjustments.

(b) During the year, Portal has transferred several of its tangible assets to a newly created company, Site plc, which is owned jointly with another company.
The following information relates to the accounting for the investment in Site plc:

	£m
Purchase cost – fixed assets transferred	200
– cash	25
	225
Dividend received	(10)
Profit for year on joint venture after tax	55
Revaluation of fixed assets	30
Closing balance per balance sheet – Site plc	300

The cash flow statement showed the cost of purchasing a stake in Site plc of £225 million.

(c) The taxation amount in the cash flow statement is the difference between the opening and closing balances on the taxation account. The charge for taxation in the profit and loss account is £191 million of which £20 million related to the taxation on the joint venture.

(d) Included in the cash flow figure for the disposal of tangible fixed assets is the sale and leaseback of certain land and buildings. The sale proceeds of the land and buildings were £1000 million in the form of an 8% loan note repayable in 2002 at a premium of 5%. The total profit on the sale of fixed assets, including the land and buildings, was £120 million.

(e) The minority interest figure in the statement comprised the difference between the opening and closing balance sheet totals. The profit attributable to the minority interest for the year was £75 million.

(f) The net cash inflow from operating activities is the profit on ordinary activities before taxation adjusted for the balance sheet movement in stocks, debtors and creditors and the depreciation charge for the year. The interest receivable credited to the profit and loss account was £27 million and the interest payable was £19 million.

Required

(a) **Prepare a revised Group cash flow statement for Portal plc, taking into account notes (a) to (f) above.** (18 marks)

(b) **Prepare a brief presentation on the usefulness and information content of group cash flow statements generally and specifically on the group cash flow statement of Portal plc.** (7 marks)

ACCA, Advanced Corporate Reporting (UK Stream), Pilot Paper (2002) **(25 marks)**

17.8 Pitted Prunes plc merged with Rosy Plums plc and changed its name to Pitted Rosy Plums plc in June 1987. The figures included in the accounts for the year ended 31 December 1987 included the results of both companies from 1 January 1987.

The financial highlights printed in the annual report showed:

	1987	*1986*
	£000	£000
Turnover		
Pitted Prunes plc	46 434	43 354
Rosy Plums plc	110 420	78 050
	156 854	121 404
Profit before taxation		
Pitted Prunes plc	4 336	4 171
Rosy Plums plc	2 019	1 144
	6 355	5 315
Shareholders' funds	38 061	35 772
	Pence per share	
Earnings per ordinary share	19.6	16.80
Dividends per ordinary share (net)	5.9	5.12

The five-year review showed:

	Pitted Rosy Plums		*Pitted Prunes*			
Year ended 31 December	*1987*	*1986*	*1986*	*1985*	*1984*	*1983*
	£000	£000 restated	£000	£000	£000	£000
Turnover	156 854	121 404	43 354	40 959	34 832	25 209
Percentage exported	52%	49%	44%	45%	44%	38%
Operating profit	8 437	6 476	4 174	3 137	2 607	1 569
Profit on ordinary activities before taxation	6 355	5 315	4 171	2 667	2 208	1 205
Profit on ordinary activities after taxation	4 538	3 940	3 040	2 072	1 836	952
Dividends:						
Preference	287	289	285	124	77	77
Ordinary	1 288	1 601	625	454	403	330
Shareholders' funds	38 061	35 772	15 470	13 529	10 066	8 590
Earnings per ordinary share	19.6p	16.8p	22.6p	16.0p	14.4p	7.1p
Dividends per ordinary share	8.1p	7.2p	7.2p	5.3p	4.7p	3.8p

Required

(a) **Explain the current requirements for a company to produce a five year summary with its annual report and the circumstances in which it may be necessary to restate the actual figures.** (5 marks)

(b) **Discuss how historical summaries may be of interest and use to an investor or potential investor.** (5 marks)

(c) **Discuss the adequacy of the five year historical summary produced for Pitted Rosy Plums plc and the minimum content that you consider desirable.** (10 marks)

ACCA Level 3, Advanced Financial Accounting, December 1989 **(20 marks)**