

Part 3

Recognition in financial statements

- 7** Published financial statements
- 8** Non-current (fixed) assets
- 9** Current assets
- 10** Current liabilities
- 11** Provisions and non-current (long-term) liabilities
- 12** Ownership interest

Chapter 7

Published financial statements

REAL WORLD CASE

Group overview

GUS is a retail and business services group. Its activities comprise general merchandise retailing through Argos Retail Group, information and customer relationship management services through Experian, and luxury goods through a majority shareholding in Burberry Group plc.



Five year summary

Profit by division	2001 £m	2002 £m	2003 £m	2004 £m	2005 £m
Continuing operations:					
Argos Retail Group					
Argos	169	212	241	298	309
Homebase	–	–	2	102	92
Financial Services	(6)	(18)	(13)	(5)	–
Wehkamp	18	19	20	21	20
	181	213	250	416	421
Experian					
Experian North America	156	155	171	180	188
Experian International	61	69	85	102	130
	217	224	256	282	318
Burberry	69	90	117	141	166
Central activities (including GGF and gusco.com)	(3)	(7)	(16)	(20)	(24)
	464	520	607	819	881
Discontinued operations:					
Argos Retail Group	36	42	35	–	–
Lewis	31	31	32	44	55
Property	30	25	26	18	–
	97	98	93	62	55
	561	618	700	881	936
Net interest	(74)	(67)	(58)	(54)	(26)
Profit before amortisation of goodwill, exceptional items and taxation	487	552	642	827	910
Amortisation of goodwill	(92)	(99)	(143)	(193)	(207)
Exceptional items	(85)	(72)	(90)	58	(10)
Profit before taxation	310	380	409	692	693
Tax on profit on ordinary activities	(106)	(122)	(141)	(192)	(221)
Profit after taxation	204	258	268	500	472
Equity minority interests	–	(1)	(17)	(27)	(49)
Profit for the financial year	204	257	251	473	423

Source: GUS Annual Report and Financial Statements 2005, p. 1 and p. 90 (Table).

Discussion points

- 1 Which activities are the main contributors to the profit of the GUS group?
- 2 What does the five-year summary tell us about GUS as a group?

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Learning outcomes

After reading this chapter you should be able to:

- Explain the key international influences that affect accounting practice in the UK.
- Explain the structure of company reporting as set out in the *Framework* and in UK guidance.
- Explain the main contents of (a) the balance sheet, (b) the income statement (profit and loss account) and (c) the cash flow statement as presented by larger companies.
- Define 'parent company' and 'subsidiary company' and explain how a group is structured.
- Explain the main features of group financial statements.
- Explain the nature of, and reason for, other forms of communication beyond the annual report.

7.1 Introduction

It is explained in Chapters 1 and 4 that in the case of sole traders and partnerships the groups of persons who have an interest in the financial statements are limited to the owners themselves, HM Revenue and Customs and organisations such as banks which are asked to provide finance for the company. For limited liability companies the list of potential users widens and the access to internal information becomes restricted. Even the owners of a limited liability company, called the equity holders (shareholders) are not permitted access to the day-to-day records of the company and are treated as being outsiders of (external to) the company they own. The quality and amount of information communicated to these users who are external to the company becomes a matter which is too important to be left entirely to the discretion of the directors running the company.

Chapter 4 outlined the various regulatory authorities which exist to establish the quality and quantity of information to be published by limited liability companies. There are over one million limited liability companies in the UK, although only a few thousand are listed on the Stock Exchange and of these only around 500 have their shares bought and sold regularly. The number of major listed companies, and their importance to the economy in terms of the funds invested in them, means it is appropriate to take them as the benchmark for current practice in external reporting. The practices applied by larger limited liability companies set a good example as a starting point for smaller ones and for organisations that are not limited liability companies, such as charitable trusts or public sector bodies.

In this chapter, and in Chapters 8 to 12, there is mention only of **limited liability companies** because the aim of this book is to provide an understanding of the accounting information published by companies. The more general word **enterprise** (meaning a business activity or commercial project) could be substituted throughout for limited liability company most of what is said in these chapters because the principles and practice described here have a wider application beyond companies, although modifications may be necessary when the needs of the users and the purposes of the enterprise are different from those relevant to a limited liability company.

7.2 International influences

Chapter 3 explained that, since January 2005, two different accounting systems have existed for companies in the UK, depending on the type of company. For the group financial statements of a listed company the accounting system set out by the International Accounting Standards Board (IASB) must be applied. All other companies, and the separate companies in the group, may choose to follow IASB standards but there is no requirement to do so. Companies that do not choose to follow the international accounting standards must continue to follow the rules of UK company law and the UK ASB's accounting standards.

For many years there has been a strong international influence on and from UK accounting practice so the change to international accounting standards in 2005 did not bring many surprises. The UK accounting standard setting body was a founder member of the International Accounting Standards Committee (IASC), set up in 1973, and has been closely involved in its work since that date. In 2001, with an organisational change, the IASC became the IASB but the close similarity between international accounting standards and UK accounting standards continued. The UK ASB has worked continuously towards matching UK standards to IFRS.

Since 1980 the law regulating financial reporting in the UK (now contained in the Companies Act 1985 and related legislation) has reflected its membership of the European Union (EU) and the work of regulators across the EU to harmonise aspects of financial reporting. From 2005 the law governing financial reporting in the UK has been split into two routes. One route is the rule of UK company law influenced by the EU. The other route is the IASB system of accounting as endorsed by the EU.

7.2.1 The European Union

The UK is a member state of the EU and is required to develop its laws so as to harmonise with those of other Member States of the EU. There are two procedures by which the EU influences the accounting practices of UK-based companies.

- 1 The European Commission, which is the permanent secretariat and staff of the EU, issues a Regulation which overrides national laws and applies to all companies specified in the Regulation.
- 2 The European Commission issues Directives which are incorporated in national laws of Member States.

The IAS Regulation

In 2002 the European Commission issued the first IAS Regulation. The IAS Regulation is a direct instruction to companies in all Member States. It required that, by 2005, all **listed** companies in the European Union would use IASB standards in preparing their **group** financial statements. This was intended to cause convergence ('bringing together') of accounting practices, and so improve the movement of capital across the stock markets of the EU. The Commission, which prepares and implements the legislation of the European Parliament, has established procedures for giving European approval to each of the IASB Standards. It takes advice from the European Financial Reporting Advisory Group (EFRAG), a team of experts that includes a UK member. The final recommendation to the Commission is made by the Accounting Regulatory Committee, which includes representatives of all Member States. The process of approving IASB standards for use in the EU is called **endorsement**.

Harmonisation through Directives

For many aspects of regulation within the EU, the process of harmonisation starts when a **Directive** is issued by the European Commission, setting out the basic rules which should be followed in each Member State's national laws. For limited liability companies in the UK, two such Directives have been particularly important. These are the Fourth Directive and the Seventh Directive. Together they specify the content of the Companies Act 1985, which was issued in 1985 and amended by a further Act in 1989. One important aspect of Directives is that they specify **formats** for the financial statements (see section 7.3.2) which ensure that all companies produce documents that are similar in appearance and present items in a systematic order. The idea of having standard formats was not a familiar concept in the UK before the Directives became effective in the 1980s, but became accepted during the 1980s and 1990. Having standard formats makes it easier for the reader to find the starting point in reading the financial statements. In later chapters we will see that having standard formats does not solve all the problems of comparability and understandability. For companies that do not apply IFRS these formats continue to apply. For companies using the IFRS there is potentially more flexibility of presentation.

Activity 7.1

From your general interest reading, or perhaps from your study of law, make a list of other areas of activity in which the UK law is harmonised with that of other countries in the EU.

7.2.2 IASB

The International Accounting Standards Board (IASB) is an independent body that sets International Financial Reporting Standards (IFRS). It was formed in 2000 as the successor to the International Accounting Standard Committee (IASC) which had been setting International Accounting Standards (IAS) since 1973. These IAS have been adopted by the IASB and will gradually be revised as IFRS. In the meantime the description 'IFRS' is used as a collective name for all forms of international accounting standard, whatever the precise title of the standard.

The IASB's objective is to bring about convergence of national accounting standards and international accounting standards to high-quality solutions. This will help participants in the world's capital markets and other users to make economic decisions.

There are many similarities between the UK accounting standards and the IASB Standards. There are also some differences where the UK standard setter believes a particular approach is justified, or where historical developments have a strong influence. The UK Accounting Standards Board works on projects with the IASB, as do other countries' standard setting bodies, all seeking to develop international convergence.

7.3 Accounting framework

Chapter 1, section 1.3 has explained that the IASB has developed a *Framework* of principles and definitions that are used in setting accounting standards. The UK ASB has also issued a *Statement of Principles*. There are many similarities between these documents because the UK ASB benefited from the earlier work of the IASB. The explanations in this chapter draw mainly on the IASB *Framework*, adding more information where this is needed to understand the separate ideas of the UK ASB.

7.3.1 The primary financial statements

The IASB requires a complete set of financial statements to comprise:¹

- a balance sheet
- an income statement (showing the profit or loss for the period)
- a statement of changes in equity
- a cash flow statement, and
- notes that summarise the accounting policies and give other explanations.

The IASB also gives general guidance on how to prepare and present the financial statements but stops short of giving precise rules on presentation. There is discretion for companies to present information in a way that best suits the company and those who are likely to use the information.

The UK ASB requires the same four primary statements but with some differences of names. The income statement is called a profit and loss account. The statement of changes in equity is replaced by two items: a statement of total recognised gains and losses and a note of changes in share capital and reserves (explained in Chapter 12 of this book). The Companies Act 1985 sets out formats of financial statements (see section 7.3.2) which give detailed rules on the sequence of information. These formats apply to companies that do *not* follow the IFRS.

A comparison of the primary statements in the IASB and UK ASB systems is shown in Exhibit 7.1.

Exhibit 7.1

Primary statements – IASB and UK ASB compared

IASB system	UK ASB and company law
Balance sheet	Balance sheet
Income statement	Profit and loss account
Cash flow statement	Cash flow statement
Statement of changes in equity	
● Statement of recognised income and expense	● Statement of total recognised gains and losses
<i>plus</i>	<i>plus</i>
● *Transactions with equity holders (e.g. dividends paid)	● Reconciliation of movements in shareholders' funds [†]
<i>plus</i>	
● *Changes in the retained earnings (accumulated profit or loss)	
<i>plus</i>	
● *Changes in each class of equity and each reserve	
Key: * may be shown on the face of the statement of changes in equity or in notes.	
† Shown with primary statements or in notes	

The IASB's Framework explains that the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.²

Financial position

Information about financial position is reported primarily in a balance sheet. It reports economic resources controlled by the company, its financial structure, its liquidity and its solvency. Information about economic resources held by the entity allows users of the information to estimate future cash flows from those resources. Information about

financial structure is useful in predicting future needs for borrowing or for raising new equity finance. Liquidity refers to the availability of cash in the near future after taking account of commitments in the same period. Solvency refers to the availability of cash to meet financial commitments as they fall due. The balance sheet is not a statement of the value of the company because there are limitations in the measurement process and also because not all items which are of value to the company are included in the balance sheet.

Performance

Information about the performance of an entity is primarily provided in an income statement (profit and loss account). Performance is indicated by profitability and changes in profitability. Information about performance is useful in evaluating how well the resources of the entity have been used to generate profit. Statements of financial performance are seen as providing an account of the stewardship of management and also as helping readers to check the accuracy of previous estimates they may have made about the expected outcome of the period.

Changes in financial position

Information about changes in financial position of an entity is useful to help assess the operating, investing and financing activities of the period. It is usually found in a statement of cash flows.

7.3.2 Formats for financial statements

The word **format** means 'shape'. A format for a financial statement sets out the shape of the document. It sets out the items to be reported and the sequence in which they are reported. Section 7.2.1 explains that EU Directives have guided the formats used by UK companies for many years, as set out in company law and UK accounting standards. Since 2005 the group financial statements of listed companies have followed the IASB system of reporting. The IASB system does not specify formats. It does provide some lists of items to be included in financial statements but there is no requirement to present these items in any particular sequence. This means that companies have choices in the shape of their financial statements. This book describes the shapes of financial statements that you are likely to see in company reports but you will need to be flexible in understanding that companies do have choices.

7.3.3 Categories of financial information

The primary financial statements are the core of a much wider range of sources of financial information which users may obtain about a company. The relative position of the primary financial statements is shown in Exhibit 7.2

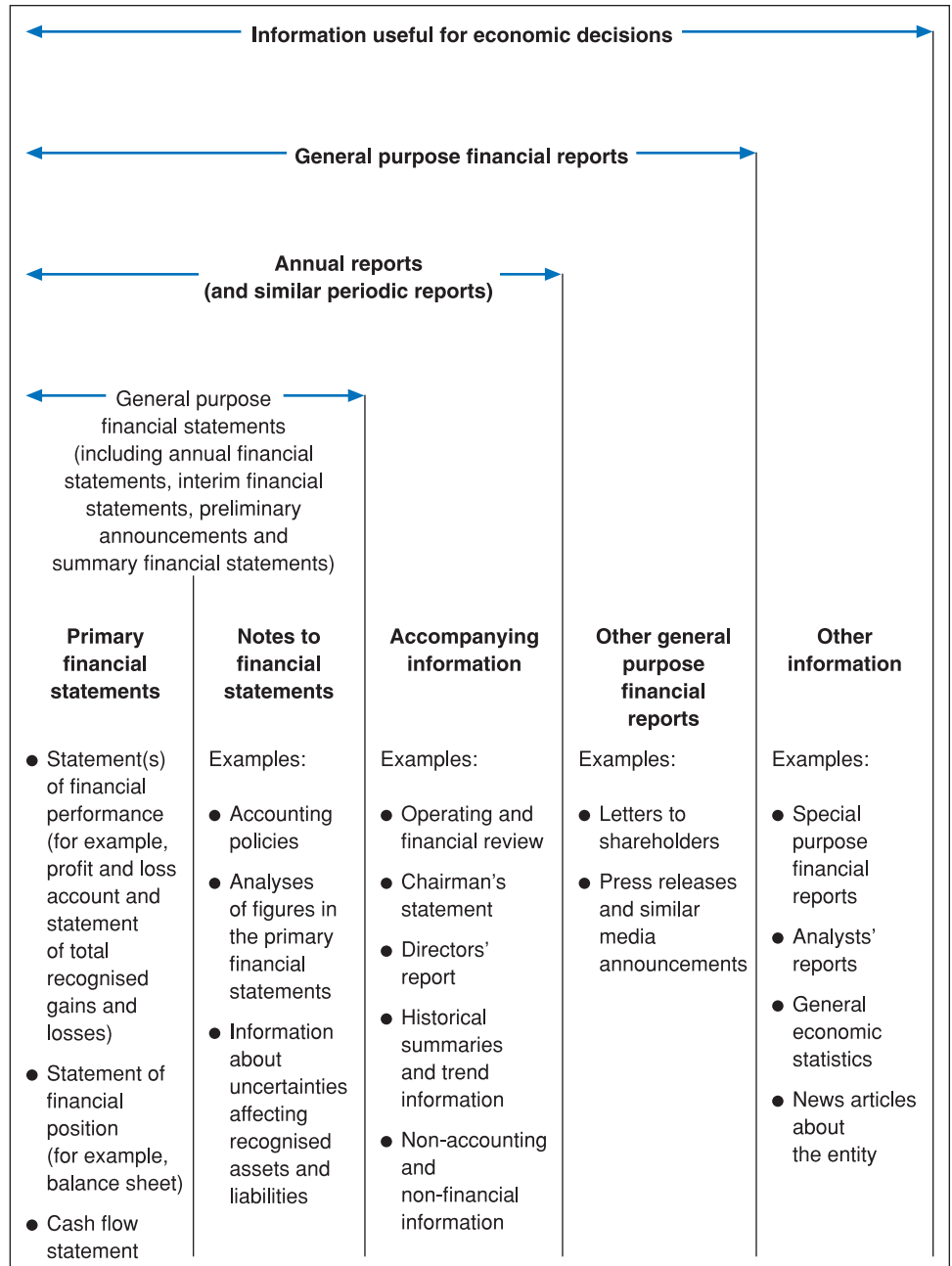
Activity 7.2

Write down three items of accompanying information about a company which you feel would be useful in the annual report of a company. Exchange lists with other members of the group and establish the similarities and differences across the group. To what extent would one general set of financial statements with notes and accompanying information meet your collective expectations?

7.3.4 Notes and accompanying information

The annual report contains the primary financial statements, notes to the financial statements and accompanying information.

Exhibit 7.2
Categories of financial information



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

Notes to the financial statements

Notes to the financial statements are essential in amplifying and explaining the primary financial statements. They may contain additional information that is relevant to the needs of users about the items in the balance sheet, income statement and cash flow statement. The notes and the primary financial statements form an integrated whole. The wording of the notes is as important as the numbers if ambiguity is to be avoided.

For companies that do not follow the IFRS, many of these notes are required by regulations such as the Companies Act 1985 or relevant UK accounting standards. The ASB also warns that notes to the accounts are not the place to correct or justify a misrepresentation in the primary financial statements. That potential misrepresentation should be dealt with by amending the financial statement to eliminate the problem.

Accompanying information

Accompanying information is any other information additional to the primary financial statements and notes. It could be information which is highly relevant but of lower reliability than the financial statements and notes. It could be information which will only interest a particular group of users. Such accompanying information may not be subject to the audit process which is compulsory for the primary financial statements and notes. The IASB does not give a view on the accompanying information beyond the notes to the financial statements. The view of the UK ASB is that such accompanying information may be very important, one example being the Operating and Financial Review now presented by large companies as management's explanation of the information given in the financial statements (see Chapter 14). Accompanying information may include disclosures of a voluntary or evolutionary nature.

Many annual reports include highlights pages showing amounts, ratios and other calculations that distil a great deal of information into a few key items. The UK ASB agrees that highlights can be useful but warns against focusing attention exclusively on one or two measures. You cannot read about financial statements for long without meeting the phrase 'the bottom line'. That refers to the line in the income statement (profit and loss account) which reports the profit attributable to the equity holders (ordinary shareholders). It may be described as **earnings** for equity holders (ordinary shareholders). When this amount is divided by the number of shares which have been issued by the company it becomes the **earnings per share**. Investors, financial journalists and brokers' analysts have traditionally paid great attention to the earnings per share. The standard setters (both the IASB and the UK ASB) would prefer to discourage this narrow focus and encourage instead a 'building block' approach where the company produces information in such a way that the user of the annual statement can create useful arrangements and combinations of information.

Companies also produce accompanying information for specialised needs. Regulated industries (such as gas, electricity, telecommunications and water) provide supplementary information about their regulated activities. Some companies give non-financial performance indicators (such as speed of answering customer enquiries, or level of customer satisfaction). Graphs, charts, diagrams and even photographs are all ways of providing accompanying information which adds to users' understanding of a document.

7.4 Balance sheet

7.4.1 What items must be reported?

Companies that follow the IASB system of accounting in presenting a balance sheet have choices in the way they present their balance sheet. There is no particular **format** required³ but some items are listed in the relevant standard as a minimum set of disclosures (see Supplement 7.1 to this chapter). Companies choose the form of layout for items in the balance sheet.

Companies that do not follow the IASB system of accounting must comply with the Companies Act 1985 and the UK accounting standards. The Companies Act 1985 contains more detail of the format that must be used. The details are set out in Supplement 7.2 to this chapter.

7.4.2 What formats are used?

Companies applying the IASB system do not have to follow any particular format but it is likely that any balance sheet you see will resemble one of the three formats described in this section because they will retain some of the traditions of the UK system that has existed for more than 20 years.

Companies that do not apply the IASB system of accounting must follow the requirements of the Companies Act 1985 and the standards of the UK ASB. The Companies Act 1985 permits two different formats of balance sheet, each conforming to the accounting equation but permitting different layouts on the page. The word format means ‘shape’ so it covers the items to be reported and the sequence in which they are reported. The most commonly used format in the UK is Format 1, which uses the accounting equation to create a vertical format as shown in Exhibit 7.3.

Exhibit 7.3
Vertical format of balance sheet

Assets
minus
Liabilities
equals
Ownership interest

Format 2 uses the accounting equation to create a horizontal format as shown in Exhibit 7.4.

Exhibit 7.4
Horizontal form of balance sheet

Assets		Ownership interest
	equal	plus
		Liabilities

Format 2 is observed more commonly in the financial statements of Continental European countries where the horizontal format is preferred.

Some companies use a variation on Format 2 which stacks the assets on top and the ownership interest and liabilities underneath (see Exhibit 7.5).

Exhibit 7.5
Assets above, ownership interest plus liabilities below

Assets
equals
Ownership interest
plus
Liabilities

When you read a balance sheet you should first of all look at the overall structure to see where the main sections of **assets**, **liabilities** and **ownership interest** are placed. Then you can begin to look at each section in more detail. The process is something like seeing a landscape painting for the first time. You stand back to look at the overall impression of the landscape and the main features first. Then you step forward to look at some of the details in different parts of the painting. Finally if you are very enthusiastic you move in closer and start to examine the details of the texture, brush strokes and shading.

7.4.3 Descriptions in the balance sheet

You will see from the Supplement that the balance sheet formats contain some words you will recognise but also many new words. Non-current assets (fixed assets) are separated from current assets. Current liabilities (due in less than one year) are separated from non-current liabilities (due in more than one year). Some of the items under the Companies Act headings A to J may look rather strange at this stage (particularly A, D, I and J). Do not worry about that at present. If they are appropriate to first-level study they will be explained at some point in this text. If they are not explained, then they are relatively rare in occurrence and the time taken to explain them will outweigh the benefits you would gain from understanding.

The ownership interest is shown at heading K as **capital** and **reserves**. The word **capital** here means the claim which owners have because of the number of shares they own and the word **reserves** means the claim which owners have because the company has created new wealth for them over the years. Various labels are used to describe the nature of that new wealth and how it is created. Some of the new wealth is created because new investors pay more than a specified amount for the shares. Paying more is referred to as paying a **premium**, so this kind of ownership interest is labelled the **share premium**. Some of the new wealth is created because the fixed assets held by the company increase in value and that new valuation is recorded. This kind of ownership interest is labelled the **revaluation reserve**. Some of the new wealth is created by making profits through operating activities. This kind of ownership interest is labelled the **retained earnings** reserve.

7.4.4 Subtotals

Subtotals in financial statements help to group information within financial statements into useful sections. There are no rules about the placing of subtotals in either the IASB lists or the Companies Acts formats. Companies have to decide for themselves where to place subtotals and totals in presentation of the list of items in the format. You will need to be flexible in reading balance sheets and using the subtotals provided.

Activity 7.3

Read again the format for the balance sheet. How many of the items there came as no surprise to you? How many looked unfamiliar? Make a note of these and check that you find out about them in later chapters.

7.4.5 Illustration

The remainder of this chapter explores the published financial statements of a hypothetical listed company, Safe and Sure plc, which operates in a service industry. There is a parent company called Safe and Sure plc and it owns some subsidiary companies that together make up a 'group'. Buildings and vehicles are the main fixed assets. The Safe and Sure Group sells recycling and cleaning services to customers based on the high reputation of the company's products and name. The Safe and Sure Group follows the IASB system of accounting and has chosen a format that is similar to Format 1 (see Exhibit 7.3).

The following illustration sets out the balance sheet of the Safe and Sure Group plc for Year 7 with comparative amounts alongside for the previous year. The balance sheet is followed by a comment on matters of particular interest.

Safe and Sure Group plc			
Consolidated balance sheet at 31 December			
	Notes	Year 7 £m	Year 6 £m
Non-current assets			
Intangible assets	1	260.3	237.6
Tangible assets	2	137.5	121.9
Investments	3	2.8	2.0
Taxation recoverable	4	<u>5.9</u>	<u>4.9</u>
		<u>406.5</u>	<u>366.4</u>
Current assets			
Inventories (stocks)	5	26.6	24.3
Amounts receivable (debtors)	6	146.9	134.7
Six-month deposits		2.0	–
Cash and cash equivalents		<u>105.3</u>	<u>90.5</u>
		<u>280.8</u>	<u>249.5</u>
Current liabilities			
Amounts payable (creditors)	7	(159.8)	(157.5)
Bank overdraft	8	<u>(40.1)</u>	<u>(62.6)</u>
		<u>(199.9)</u>	<u>(220.1)</u>
<i>Net current assets</i>		80.9	29.4
<i>Total assets less current liabilities</i>		<u>487.4</u>	<u>395.8</u>
Non-current liabilities			
Amounts payable (creditors)	9	(2.7)	(2.6)
Bank and other borrowings	10	(0.2)	(0.6)
Provisions	11	<u>(20.2)</u>	<u>(22.2)</u>
<i>Net assets</i>		<u>464.3</u>	<u>370.4</u>
Capital and reserves (ownership interest)			
Called-up share capital	12	19.6	19.5
Share premium account	13	8.5	5.5
Revaluation reserve	14	4.6	4.6
Retained earnings	15	431.6	340.8
<i>Equity holders' funds</i>		<u>464.3</u>	<u>370.4</u>

7.4.6 Discussion

The first feature to note is the title, *Consolidated balance sheet*. Companies listed on the Stock Exchange are generally using one name as an umbrella for a group of several companies linked together under one parent. It is thought to be more useful to the shareholders of the parent company to see all the assets controlled by that company within the single financial statement. The word **control** is important here. The parent company owns the other companies. They each own their separate assets. The parent company controls the use of those assets indirectly by controlling the companies it owns. The balance sheet as presented here represents a group where the parent company owns 100% of all the other companies in the group (called its subsidiary undertakings). A similar consolidated balance sheet would be produced if the parent owned less than 100%, provided it had the same element of control. The only additional item would be a **minority interest** in the ownership claim to indicate the proportion of the equity interest in subsidiaries held by shareholders outside the group. The minority interest is also called a **non-controlling interest**.

The second feature to note in the balance sheet as presented is that there are two columns of figures. Companies are required to present the figures for the previous year, in order to provide a basis for comparison.

The balance sheet follows the accounting equation and this company has helpfully set out in the left-hand margin the main elements of the equation. There are some phrases in the balance sheet which you are meeting for the first time but you should not feel intimidated by new titles when you can work out what they mean if you think about the ordinary meanings of words.

Intangible assets means assets which may not be touched – they have no physical existence. Examples are the goodwill of a business or the reputation of a branded product.

Tangible non-current (fixed) assets is another phrase which you are seeing here for the first time, but again you can work out the meaning. You know from Chapter 2 what **non-current assets** are and you know that tangible means ‘something that may be touched’. So you would not be surprised to find that note 2 to the accounts gives more detail on land and buildings, plant, equipment, vehicles and office equipment.

Investments here means shares in other companies which are not subsidiary undertakings within the group.

The *taxation recoverable* is an amount of tax which has been paid already but may be reclaimed in 18 months’ time because of events that have occurred to reduce the tax due, after the tax was paid.

Current assets comprise inventories (stocks), receivables (debtors) and cash. They are set out in order of increasing liquidity. Inventories (stocks) are the least readily convertible into cash while amounts receivable (debtors) are closer to collection of cash. Cash itself is the most liquid asset. The notes to the accounts contain more detailed information. Take as an example note 4, relating to inventories (stocks). It appears as follows:

Note 4	Year 7	Year 6
Inventories (stocks)	£m	£m
Raw materials	6.2	5.4
Work-in-progress	1.9	1.0
Finished products	<u>18.5</u>	<u>17.9</u>
	<u>26.6</u>	<u>24.3</u>

The notes are shown in full in Appendix I at the end of this book. There is a note relating to amounts receivable (debtors), mainly relating to trade receivables (trade debtors). Amounts payable (creditors) has a similar type of note to the balance sheet.

The *non-current liabilities* include long-term borrowings, which are quite low in amount compared with those of many other companies of this size. The provisions relate to future obligations caused by: treating a contaminated site; reorganisation of part of the business; and future tax payable.

That stage of the balance sheet concludes with the net assets, defined as all assets minus all liabilities. Drawing a total at this point is not a requirement of any format, but is used by many companies as the point which creates a pause in the balance sheet before moving on to the ownership interest.

For a company the *ownership interest* is described as *capital and reserves*. The ownership interest in a company is specified in company law as comprising the claim created through the shares owned by the various equity holders (shareholders) and the claim representing additional reserves of wealth accumulated since the company began. That wealth is accumulated by making profits year after year. The claim is reduced when the owners take dividends from the company. (Further information on the reporting of share capital, reserves and dividends is contained in Chapter 12.)

The ownership interest is the part of the balance sheet which causes greatest confusion to most readers. It is purely a statement of a legal claim on the assets after all liabilities have been satisfied. The word *reserves* has no other significance. There is nothing to see, touch, count or hold. To add to the potential confusion, company law delights in finding names for various different kinds of ownership interest. If you are the kind of person who takes a broad-brush view of life you will not worry too much about share premium account, revaluation reserve and retained earnings.

They are all part of accounting terminology which becomes important to a company lawyer when there is a dispute over how much dividend may be declared, but are less important to the investor who says 'How much is my total claim?'

7.5 Income statement (profit and loss account)

7.5.1 What items must be reported?

Companies that follow the IASB system of accounting in presenting an income statement must report the profit or loss for the period. There is no particular format required⁴ but some items are listed in the relevant standard as a minimum set of disclosures (see Supplement 7.4 to this chapter). Companies choose the form of layout of the items in the income statement.

Companies that do not follow the IASB system of accounting must comply with the Companies Act 1985 and the UK accounting standards. The Companies Act 1985 contains more detail of the items to be reported and the format that must be used. The details are set out in Supplement 7.3 to this chapter.

7.5.2 What formats are used?

Companies applying the IASB system do not have to follow any particular format but it is likely that any income statement (profit and loss account) you see will resemble one of the formats described in this section because they will retain some of the traditions of the UK system that has existed for more than 20 years.

Companies that do not apply the IASB system of accounting must follow the requirements of the Companies Act 1985 and the standards of the UK ASB. The Companies Act 1985 permits four different formats of profit and loss account but the version most frequently observed in the UK is format 1 (see Supplement 7.4).

7.5.3 Illustration

The published income statements (profit and loss accounts) of most major companies are very similar to the illustration set out here for Safe and Sure plc.

Safe and Sure Group plc			
Consolidated income statement (profit and loss account)			
for the years ended 31 December			
	<i>Notes</i>	Year 7 £m	Year 6 £m
Continuing operations			
Revenue	16	714.6	589.3
Cost of sales	16	(491.0)	(406.3)
Gross profit		223.6	183.0
Distribution costs		(2.2)	(2.5)
Administrative expenses	17	(26.2)	(26.5)
Profit from operations		195.2	154.0
Interest receivable (net)	18	2.3	3.0
Profit before tax	19	197.5	157.0
Tax	20	(62.2)	(52.4)
Profit for the period from continuing operations		135.3	104.6
Discontinued operations			
Loss for the period from discontinued operations	21	(20.5)	(10.0)
Profit for the period attributable to equity holders		<u>114.8</u>	<u>94.6</u>
Earnings per share	22	11.74	9.71

7.5.4 Discussion

The first point to note is the heading. This is a consolidated income statement (profit and loss account) bringing together the results of the activities of all the companies in the group during the year. The individual companies will also produce their own separate profit and loss accounts and these are added together to produce the consolidated picture. Where one company in the group sells items to another in the group, the sale and purchase are matched against each other on consolidation so that the results reported reflect only sales to persons outside the group.

The second point to note is that the income statement (profit and loss account) as presented by the company is more informative than the lists contained in Supplements 7.3 or 7.4 might suggest. That is partly because the company has used subtotals to break up the flow and make it digestible for the reader. One very common subtotal is the **gross profit** calculated as revenue minus the cost of the goods or services sold as revenue.

Starting at the top of the income statement we see that the word *revenue* is used to describe the sales of goods or services. **Revenue** is sometimes described as **turnover** or **sales**. Revenue (turnover) represents sales to third parties outside the group of companies. The **cost of sales** is the total of the costs of materials, labour and overheads which relate closely to earning the sales. The gross profit is sometimes referred to as the **gross margin** and is monitored closely by those who use the financial statements to make a judgement on the operations of the company. Within any industry the gross profit as a percentage of revenue (or turnover, or sales) is expected to be within known limits. If that percentage is low then the company is either underpricing its goods or else taking the market price but failing to control costs. If the percentage is high, then the company is perhaps a market leader which can command higher prices for its output because of its high reputation. However, it might also be seen by customers and competitors as charging too much for its goods or services.

The next item in the profit and loss account is *distribution costs*, which would include the costs of delivering goods to customers. For this company the distribution costs are low because it provides services by contract and does not carry out much distribution work. For many users the trends in an amount are more interesting than the actual amount. They might ask why the amount has decreased. On the other hand, it is not a particularly significant component of the overall picture and the users might show little interest. They would pay more attention to the *administrative expenses*, a collective term for all those costs which have to be incurred in order to keep the business running but which are less closely related to the direct activity of creating revenue (making sales). The directors' salaries, head office costs and general maintenance of buildings and facilities are the kinds of details brought together under this heading. Directors' salaries are always a matter of some fascination and companies are expected to give considerable detail in the notes to the accounts about how much each director is paid and what other benefits are provided.

The *profit from operations* is the end of the first stage of the profit and loss account, where the story of the business operations is complete. The rest of the profit and loss account is concerned with the cost of financing the company.

Interest is paid on loans and received on investments, usually brought together in one net amount which shows, in this case, an excess of interest receivable over interest payable. That suggests a fairly cash-rich company with relatively low levels of borrowing. Next comes the *corporation tax*, which all companies must pay as a percentage of the profit before tax. The percentage is a standard percentage applied to the profit calculated according to the tax rules. Because the tax rules are not identical to the accounting rules, the percentage appears to vary when the reader looks at the profit and loss account. Helpful companies will explain the tax charge in the Operating and Financial Review, as well as providing more detailed notes to the accounts on the tax charge.

That information ends with the profit for the period from continuing operations. Investors or analysts who want to make a forecast of future profits may decide to use this figure as a starting point because the activities will continue. Separately below this line the group shows the results in this period of operations that have been discontinued. Usually operations are discontinued because they are performing poorly so it is no great surprise to see a loss here. The loss is part of the performance of the period but investors can see that the bad news of this operation will not continue in future. Finally the equity holders (ordinary shareholders) see the profit for the period attributable to them.

They do not see here any mention of a reward in the form of a dividend which returns to them some of the wealth created by the company during the period. That information will appear in a statement of changes in equity which is explained in Chapter 12.

7.6 Cash flow statement

The presentation of cash flow statements by companies is guided by IAS 7, *Cash Flow Statements*. (There is a UK standard, FRS 1, which sets out a different form of cash flow statement⁵ but in this chapter the version required by IAS 7 is used because it is more likely that you will find this one in published financial statements.)

The benefits of cash flow information are explained in IAS 7.⁶ A cash flow statement, when used in conjunction with the rest of the financial statements, provides users with information on solvency and liquidity. It shows how cash is generated in the business and helps users to understand how much flexibility is available to adapt to changing circumstances and opportunities.

7.6.1 What items must be reported?

The cash flow statement presents three classifications of cash flows.⁷ These are:

- operating activities
- investing activities
- financing activities.

Definitions

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

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 contributed equity and borrowings of the entity.

Safe and Sure uses these classifications, as shown in the next section. We need two more definitions of terms in the cash flow statement. These are **cash** and **cash equivalents**.

Definitions

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.⁸

7.6.2 Illustration

Safe and Sure Group plc			
Consolidated cash flow statement for the years ended 31 December			
	Notes	Year 7 £m	Year 6 £m
Cash flows from operating activities			
Cash generated from operations	23	196.7	163.5
Interest paid		(3.1)	(2.4)
UK corporation tax paid		(20.1)	(18.3)
Overseas tax paid		(30.5)	(26.5)
Net cash from operating activities		143.0	116.3
Cash flows from investing activities			
Purchase of tangible non-current assets		(60.0)	(47.5)
Sale of tangible non-current assets		12.0	10.1
Purchase of companies and businesses	25	(27.7)	(90.1)
Sale of a company		3.1	–
Movement in short-term deposits		(30.7)	36.3
Interest received		5.0	5.9
Net cash used in investing activities		(98.3)	(85.3)
Cash flows from financing activities			
Issue of ordinary share capital	27	3.1	2.0
Dividends paid to equity holders		(29.5)	(24.4)
Net loan movement (excluding overdraft)	26	16.2	(24.0)
Net cash used in financing activities		(10.2)	(46.4)
Net increase/(decrease) in cash and cash equivalents*		34.5	(15.4)
Cash and cash equivalents at the beginning of the year		27.9	45.3
Exchange adjustments		2.8	(2.0)
Cash and cash equivalents at the end of the year	29	<u>65.2</u>	<u>27.9</u>

* Cash on demand and deposits of maturity less than three months, net of overdrafts.

Note 23 Cash flow from operating activities Reconciliation of operating profit to net cash flow from operating activities

	Year 7 £m	Year 6 £m
Profit before tax from continuing operations	195.2	154.0
Loss from discontinued operations	(20.5)	(10.0)
Profit from operations	174.7	144.0
Depreciation charge	33.2	30.1
Increase in inventories (stocks)*	(1.9)	(1.1)
Increase in trade receivables (debtors)*	(7.4)	(5.3)
Decrease in trade payables (creditors)*	(0.4)	(3.6)
Net cash inflow from continuing activities	198.2	164.1
Cash outflow in respect of discontinued item	(1.5)	(0.6)
Net cash inflow from operating activities	<u>196.7</u>	<u>163.5</u>

* Note: It is not possible to reconcile these figures with the balance sheet information because of the effect of acquisitions during the year.

7.6.3 Discussion

The first line of the cash flow statement is *cash flows from operating activities*, highlighted by the company as an important feature. Note 23 to the accounts explains why this is not the same as operating profit. When a company makes a profit it earns revenue which is greater than the expenses. Some of the revenue is collected as cash but some will be collected later when the credit customers pay. When expenses are incurred, some are paid for immediately but others relate to goods and services taken from

suppliers. Note 23 to the accounts is set out above and shows that cash is generated by profits but is used when inventory (stock) levels increase and when trade receivables (debtors) increase. Allowing inventories (stocks) to increase will use up cash because more has to be paid for them. Allowing trade receivables (debtors) to increase means that credit customers are not paying the cash so fast and therefore the cash is not coming in. That will diminish cash flow. Allowing trade payables (creditors) to decrease is a further way of diminishing cash flow because it means that suppliers are being paid faster.

There is one other line in note 23 which gives pause for thought. That is the fourth line *depreciation charge*. **Depreciation** is a measure of how much a fixed asset has been used up. It is an amount which is deducted from profits as a measure of using up the cost of the fixed asset in the accounting period. It does not of itself generate cash, but it stops the owners removing so much cash from the company that they are unable to replace a fixed asset at the end of its useful life. Since it is not a cash item it has to be added back to the reported profit. By way of illustration, suppose a company pays £100 for goods and sells them for £150. It has generated £50 cash. In the profit and loss account £10 is deducted for depreciation, so the reported profit becomes £40. The reconciliation of profit to cash flow from operations will be written as:

	£
Operating profit	40
<i>add</i> Depreciation	<u>10</u>
Cash inflow from operating activities	<u>50</u>

There is more about depreciation in Chapter 8 and more about cash flow in Chapter 14.

The cash generated from operations is used first of all to pay interest on loans, as a reward to lenders, and to pay taxation to the government. Deducting these items leaves the net cash from operating activities. This is the amount left over for long-term investment.

In the next section we find the cash flows from investing activities. The purchase of tangible non-current (fixed) assets is also called **capital expenditure**. Cash is paid to purchase new businesses and cash is received from selling companies or businesses no longer required. Safe and Sure has put some of its cash into short-term deposits to earn interest. In Year 6, Safe and Sure reduced the amount on short-term deposit, converting it back to cash that was available for spending, but in Year 7 it increased the amount on deposit, reducing the amount of cash available to spend in other ways. The final item in this investment section is interest received which is the reward for investment.

The third section shows the cash flows from financing activities. For some companies the cash inflow from operating activities may be insufficient to cover all the investment requirements for capital expenditure and acquisitions, so more finance has to be raised from external sources. Safe and Sure is not in such a difficult position because the cash generated from operations is greater than the cash paid out for investing activities. However there is one further important outflow in the dividends paid to equity holders (shareholders). Dividend is the reward to equity holders (shareholders) for investing in the company. For the particular cash flow statement presented here, the broad story is that the company generated sufficient cash from its operations to cover loan interest, to pay the tax due, meet its investment needs and pay dividends. Despite that positive amount, the company has increased its loans by £16.2m and marginally increased its share capital by £3.1m, so that a total of £34.5m has been added to cash and deposits repayable on demand.

The company explained its cash flow management as follows in the Operating and Financial Review: 'The group's businesses are structured to use as little fixed and working capital as is consistent with the profit and earnings growth objective in order to produce a high cash flow.'



DAVID WILSON comments on cash flow in the company: *Cash is an important factor for any business. It is only one of the resources available but it is the key to survival.*

What I'm basically looking for in the cash flow statement is how well the company is balancing various sources of finance. It generated £196.7m from operating activities. The servicing of investment cost £3.1m in loan interest and the company paid taxes of £50.6m. That left net cash from operations amounting to £143.0m. That was used to cover its investing activities in new fixed assets costing £48m (£60m less £12m) and acquisitions costing £24.6m after allowing for the sale of a company. Cash was used to increase short-term deposits by £30.7m. Interest received was £5m. The net cash used for investing activities amounted to £98.3m. If I deduct this from the £143m cash flow generated there is an increase in cash of £44.7m. The company had to pay a dividend of £29.5m, leaving £15.2m surplus cash. There was no immediate need for any long-term financing flows with a healthy cash flow like that. Nevertheless the company raised £3.1m in cash cash through an issue of shares to the employees' share option scheme and, perhaps surprisingly, there was an increase of £16.2m in short-term loans. Add the £15.2m to the £3.1m and £16.2m and you arrive at £34.5m which is the increase in cash and cash equivalents of the period. That brings me back to my earlier question of why they are holding so much cash and short-term deposits.

The company in this example has told me that it carries out its financial management by recognising that the tax bill has to be paid first of all. Then it plans its investment in fixed assets and its programme of disposals. Once the investment has been decided the company aims to pay a dividend which will satisfy the expectations of investors. Surplus cash after that is available for acquisition of other companies and, because this company is always looking for good opportunities to expand, it will borrow ahead of time so that it is in a position to move quickly when a target presents itself. The company does not agree with IAS 7's requirement to separate out the bank deposits which had more than three months to run when they were made. The deposits are placed largely for six months, so that many have less than six months to run at the balance sheet date. It is all very accessible cash and the company sees it all as one pool.

In the Operating and Financial Review the finance director explains the company's view of cash flow as follows:

The Group's businesses are structured to utilise as little fixed and working capital as is consistent with the profit and earnings growth objective in order to produce a high cash flow. The impact of working capital on cash flow was held to an increase in Year 7 of £9.7m (Year 6: £10.0m).

A net cash flow of £196.7m was generated from operating activities. That was boosted by other amounts of cash from interest received. After paying interest and tax, the Group had £143.0m remaining. Fixed assets required £48.0m after allowing for the proceeds of selling some of our vehicle fleet in the routine replacement programme. That left £95m from which £24.6m was required to pay for acquisitions. The remaining £70.4m covered dividends of £29.5m leaving £40.9m. We received £5m interest on investments and raised £3.1m in ordinary share capital to give a net inflow of liquid funds in the year of £49.0m. Out of that amount, short-term deposits have increased by £14.5m, leaving an increase in cash of £34.5m.

You can see there are lots of different ways of interpreting the information in the cash flow statement. What is important is that the information is available.

7.7 Group structure of companies

Most major companies in the UK operate using a group structure. Within a group there is a **parent** company which controls **subsidiary** companies undertaking various different aspects of the operations of the business. It would in theory be possible to have all the operations located within one company but in practice, because company law draws very tight boundaries around a single company, there is some safety for the organisation in having different parts of the business packaged separately. If something goes seriously wrong with one subsidiary company, that company may be allowed to fail without irreparable damage to the total group. This approach has not always worked out in practice because very often the banks which lend money to a subsidiary will request guarantees from other companies in the group. So if one subsidiary fails in a spectacular way, it may drag the rest of the group with it.

Other reasons for retaining separate subsidiaries include: employee loyalty, product reputation, taxation legislation and overseas operations. When a new company is taken into the group, a sense of pride in the formerly independent company may be retained by continuing to use the traditional company name. The company name may be linked to a reputation for a high-quality product so that it is desirable to perpetuate the benefit of that reputation. Tax legislation applies to individual companies and not to the group as a whole. Efficient use of the tax laws may require different types of business to operate in different companies. Operations located in other countries will come under the legal systems of those countries and may be required to have a separate legal identity.

For accounting purposes the group as a whole is the economic entity for which financial statements are prepared. An entity should prepare and publish financial statements if there is a legitimate demand for the information that its financial statements would provide and it is a cohesive economic unit.⁹ The process of combining all the financial statements of the companies within a group is called **consolidation**. This chapter will explain sufficient aspects of the preparation of consolidated financial statements to allow an understanding of annual reports of groups of companies. The full complexities of consolidation and the wider aspects of group accounting may be found in advanced textbooks.

Definition

Consolidated financial statements are the financial statements of a group presented as those of a single economic entity.¹⁰

Consolidated financial statements recognise the parent's control of its subsidiaries. Consolidation is a process that aggregates the total assets, liabilities and results of all companies in the group. The consolidated balance sheet brings together all the assets controlled by the parent and shows all the liabilities to be satisfied from those assets. The consolidated income statement (profit and loss account) brings together all the revenues and costs of the companies in the group.

7.7.1 Defining a group

The smallest group consists of two companies. A group is created when one company (the **parent**) has **control** of another company (the **subsidiary**). There is no upper limit to the number of companies which may form a group.

The International Accounting Standards Board has defined a group as a parent and all its subsidiaries.¹¹ A parent is an entity that has one or more subsidiaries.¹² A subsidiary is an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the **parent**).¹³ **Consolidated** financial statements must include all **subsidiaries** of the parent.¹⁴

Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.¹⁵ Control is presumed to exist when the parent owns, directly or indirectly, more than half of the voting power of an entity. Control also exists where the parent owns half or less than half of the voting power of an entity where there is:¹⁶

- (a) power over more than half of the voting rights by virtue of an agreement with other investors;
- (b) power to govern the financial and operating policies of the entity under a statute or an agreement;
- (c) power to appoint or remove the majority of the members of the board of directors or equivalent governing body;
- (d) power to cast the majority of votes at a meeting of the board of directors or equivalent governing body.

7.7.2 The importance of control

Control describes the highest degree of influence that an investor can have over its investee. If an investor (the parent) controls its investee (the subsidiary), it has the ability to direct the investee's operating and financial policies with a view to gaining economic benefit from its activities. The parent becomes fully accountable for the risks and rewards arising from its subsidiary's activities and obtains access to any benefits generated by the subsidiary's activities.

Whatever the percentage holding, the concept of control is the guiding principle which allows the consolidated balance sheet to report *all* the assets and *all* the liabilities of the combined companies. The consolidated profit and loss account reports *all* the profit generated by those assets and liabilities.

7.7.3 The parent company's balance sheet

In some annual reports the parent company may choose continue to produce its own balance sheet, showing as an asset the cost of the investment in the subsidiary, but this information is not regarded as being particularly useful. The investment in the subsidiary is reported by the parent company as a single-line item but the consolidated balance sheet shows all the assets and all the liabilities of the group under each separate heading. The group balance sheet is more useful to readers. In previous chapters, where the financial statements of Safe and Sure plc have been discussed, the group accounts have been used.

7.7.4 Acquisition

The general term **business combination** may be applied to any transaction whereby one company becomes a subsidiary of another. The most common form of business combination is an **acquisition** where one party (the **acquirer**) is clearly the dominant entity and the other (the **acquiree**) is seen to be under new control. The method of accounting used to produce consolidated financial statements in an acquisition is called the **acquisition method** (also described as the **purchase method**).¹⁷ In this introductory text you do not need to worry about the details of the method of producing consolidated financial statements. All you need to do is recognise the descriptions used and be aware that when you see these words you are reading information about a group of companies combined.

Activity 7.4

Check your understanding of the terms: parent, subsidiary, control, acquisition. Write down a definition of each and then look back through this section to test your definition against that in the text.

7.8 Group financial statements

This section explains how the acquisition of a subsidiary affects the balance sheet of the parent company. It shows how the group's balance sheet and income statement (profit and loss account) are created. It also explains the nature of goodwill arising on acquisition and it outlines the nature and treatment of associated companies.

7.8.1 The parent company's balance sheet

When an acquisition takes place, the parent company acquires shares in the subsidiary in exchange for cash or for shares in the parent. The parent company will offer cash if it has adequate cash resources to make the offer and it appears that those selling the shares would prefer to take cash for investment elsewhere. The parent company will offer its own shares in exchange where it may not have sufficient cash resources available or where it thinks it can persuade those selling their shares in the target company of the desirability of acquiring shares in the new parent. Many deals offer a mixture of shares and cash.

For a cash purchase the effect on the parent company's balance sheet, in terms of the accounting equation, is:

Assets ↑↓	–	Liabilities	=	Ownership interest
Decrease in asset of cash Increase in asset of investment in subsidiary				

For a share exchange, the effect on the parent company's balance sheet is to increase the assets and increase the ownership interest. In terms of the accounting equation:

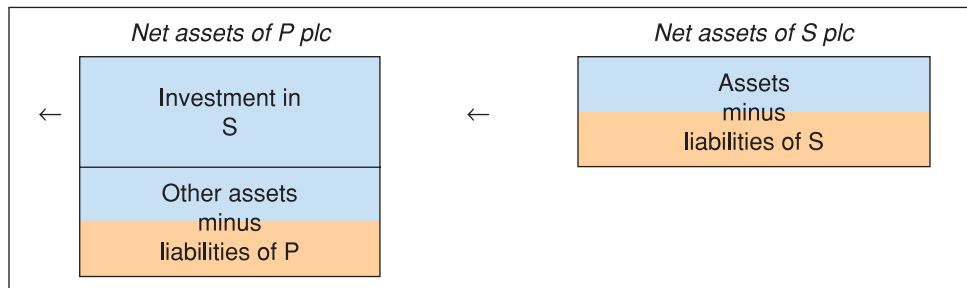
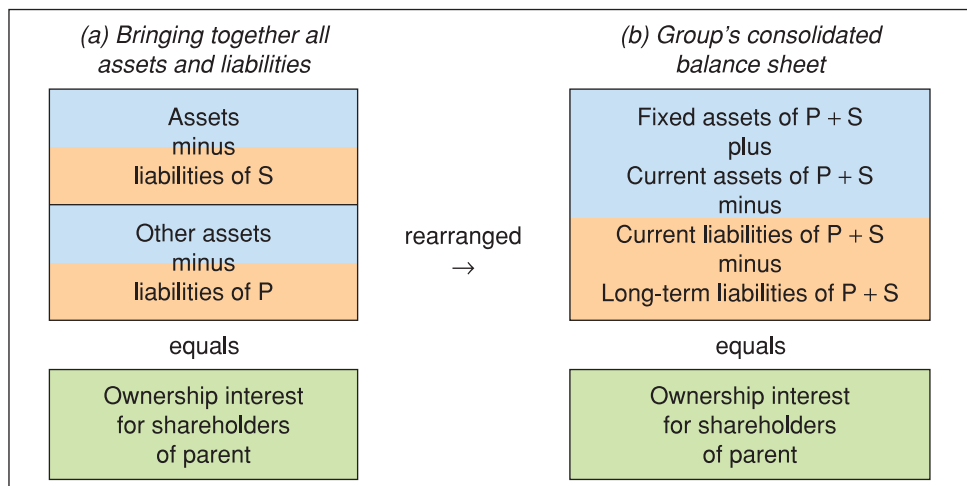
Assets ↑	–	Liabilities	=	Ownership interest ↑
Increase in asset of investment in subsidiary				Increase by new shares issued

7.8.2 The group's consolidated balance sheet

In the group's consolidated balance sheet the parent company's assets and liabilities are added to the assets and liabilities of the subsidiary companies. The assets and liabilities of the subsidiary take the place of the parent company's investment in the subsidiary. Exhibit 7.6 shows the net assets of P and S separately. The arrows indicate the net assets of S moving in to take the place of P's investment in S. Removing the investment in S from the balance sheet of P and replacing it with the net assets of S leads to the group's consolidated balance sheet. Exhibit 7.7(a) shows the resulting amalgamation. The assets and liabilities in Exhibit 7.7(a) are then rearranged under each asset and liability category to result in Exhibit 7.7(b).

7.8.3 The group income statement (profit and loss account)

Investors and their advisers may wish to use the income statement (profit and loss account) of the group to make predictions of the future profitability of the group. To be able to do this, they must know how much of the current year's profit relates to continuing operations and how much relates to changes during the year. The illustration of the income statement of Safe and Sure plc in section 7.5.3 shows how the consolidated profit and loss is subdivided into continuing activities and discontinued activities.

Exhibit 7.6**Separate net assets of parent and subsidiary****Exhibit 7.7****Completing the process of consolidation**

One rule of acquisition accounting is that, where a subsidiary is acquired part-way through the year, only the profits earned after the date of acquisition may be included in the group profit and loss account. The analyst seeking to make a forecast for the year ahead will be helped by a note to the accounts showing what the profit would have been from a full 12-month contribution.

Groups are not required to present separately the parent company's income statement (profit and loss account). It is not felt to be particularly interesting to users as, generally, the parent company's main income comprises the dividends received from its investments in subsidiaries. Usually it is the subsidiaries which carry out the operations generating profit. It is far more interesting to know about the underlying operating profits which allow those dividends to be paid to the parent.

Activity 7.5

P plc pays cash of £6m for an investment in net assets of S Ltd having a net book value (equal to fair value) of £6m. Explain how this transaction will affect the balance sheet of P plc as the parent company and explain how it will affect the group balance sheet of P Group plc, whose only subsidiary is S Ltd.

7.8.4**Goodwill on acquisition**

In the illustration presented in Exhibit 7.6 and Exhibit 7.7 the net assets of the subsidiary were shown as being of the same magnitude as the amount of the investment

in the subsidiary so that the substitution of the former for the latter was a neat replacement process. That situation is unlikely to apply in real life because the price paid for an investment will rarely depend solely on the net assets being acquired. The purchaser will be looking to the future expectations from the investment and the seller will be seeking a reward for all that has been built into the business which cannot readily be quantified in terms of tangible assets. The future expectations will rest upon the reputation of the product or service, the quality of the customers, the skills of the workforce and the state of the order book, amongst many other things. The price negotiated for the business will include some recognition of all these qualities under the global heading of **goodwill**.

In these circumstances the price paid for the investment in the subsidiary will be greater than the amount of the net assets of the subsidiary. When the consolidation into the group balance sheet is attempted, a space will appear. Exhibit 7.8 shows the separate net assets of P plc and S plc. The amount of the cost of the investment in S is greater than the net assets of S plc.

Exhibit 7.8

Net assets of the separate companies P plc and S plc

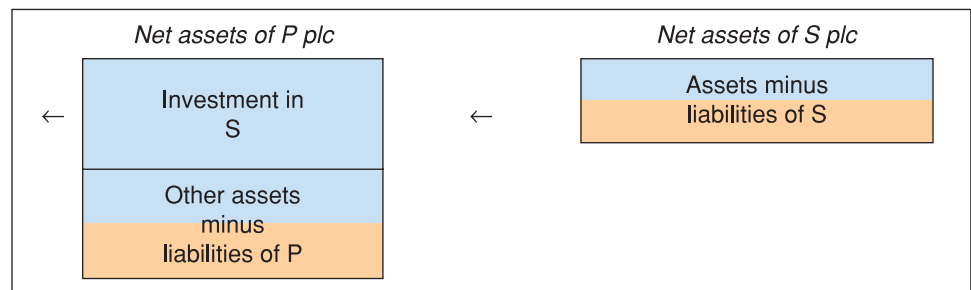
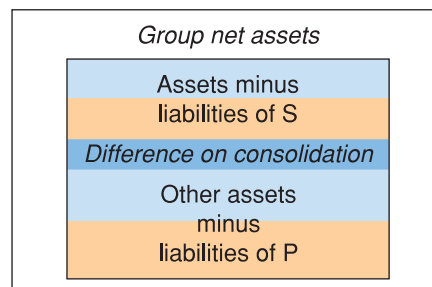


Exhibit 7.9 shows the resulting consolidation. The space shaded is equal to the difference between the amount of the investment in S and the net assets of S. This space is, in arithmetic terms, nothing more than a **difference on consolidation** but has traditionally been called **goodwill** because it is explained in terms of paying for something more than the underlying net assets.

Exhibit 7.9

Group net assets of the P group



Definition

Goodwill is defined as future economic benefits arising from assets that are not capable of being individually identified and separately recognised.¹⁸

Goodwill is recognised in the balance sheet as an asset and is measured as the excess of the cost of the business combination over the fair value of the net assets acquired.¹⁹

The existence of a difference on consolidation is an inescapable consequence of the process of combining the balance sheets of parent and subsidiary. For many years it caused one of the most difficult problems facing the accounting standard setters. The questions asked were: 'How should this consolidation difference be reported in the balance sheets of succeeding years?' and 'Is it an asset?'

After a great deal of international debate and disagreement, the IASB has taken the view that acquisition goodwill is an asset that should be tested regularly by means of an **impairment test** which asks, 'Can the business expect to recover the carrying value of the intangible asset, through either using it or selling it?' If the answer is 'no' then the asset is impaired and its value must be reduced. An expense of impairment will appear in the income statement (profit and loss account). If the answer is 'yes' then the asset value should remain in the balance sheet.

Definition

Impairment means 'damaged' or 'spoiled'. Where the carrying value of goodwill cannot be recovered through sale or use, it is said to be 'impaired'. The asset value in the balance sheet must be reduced.

Activity 7.6

P pays cash of £8m for an investment in net assets of S Ltd having a net book value (equal to fair value) of £6m. Explain how this transaction will affect the balance sheet of P plc as the parent company and explain how it will affect the group balance sheet of P Group plc, whose only subsidiary is S Ltd.

7.8.5 Associated companies

Where company P holds less than a controlling interest in company A, it may nevertheless have a significant influence over company A. Such significant influence would involve the power to participate in the financial and operating policy decisions of company A. Significant influence is presumed to exist when one company or a group of companies holds 20% or more of the ordinary shareholders' voting rights of another company, unless the facts indicate that significant influence is not possible.²⁰

Where significant influence over a company exists, that company is called an **associated company**. The group must show in its balance sheet the group's share of the net assets of the associated company as a single line item, and must show in the income statement (profit and loss account) the group's share of the profits or losses of the associated company.

This treatment of an investment in an associated company is called **equity accounting** because it reports the parent's and the group's share of the investment in the ownership interest (also referred to as the equity).

For investments which do not meet the conditions of being reported as associated companies, the accounting treatment is to record the investment at cost in the balance sheet and to record in the profit and loss account of the group only the dividend income received from the associate.

7.9 Beyond the annual report

The annual report is a regulated base of information on which a reporting cycle is built. The cycle begins when the company makes its first announcement of the results of the financial year. This announcement is made in a manner dictated by Stock Exchange rules and is called a 'preliminary announcement' because it is a preliminary

to the issue of the full annual report. It is also called a 'press release' because it forms the basis of the information which first appears in the financial press.

The cycle continues with reports being issued in the period between annual reports. These are called 'interim reports'. The London Stock Exchange requires half-yearly reports. The regulators of the US stock exchanges require quarterly reports. All UK listed companies provide half-yearly reports and some voluntarily provide quarterly reports.

Other questions arising beyond the annual report are:

- What help exists for small and medium-sized companies to reduce the burden of communication for regulatory purposes?
- How do larger companies avoid information overload for their shareholders?
- Can users have confidence in additional information provided beyond the annual report?
- What developments is the UK government currently implementing or planning?

This section outlines developments on these issues.

7.9.1 Preliminary announcements

The **preliminary announcement** is the first external communication of the financial performance and position of a company in relation to the financial year most recently completed. When the year-end results and half-yearly results are ready for publication, a preliminary announcement of key information is made in a manner set out by the Stock Exchange which aims at fair and equal access for all investors. The preliminary announcement is usually accompanied by a press release, giving the information to the media, and by meetings with professional investors and brokers' analysts at which key personnel in the company (usually the chairman, chief executive and finance director) will make speeches and answer questions.

The institutional shareholders and their advisers will form expectations about the position and performance in advance of the announcement. They look carefully at the preliminary announcement in comparison with their expectations.

Company law does not prescribe the content of the preliminary announcement or the interim report. The Company Law Review report of 2001 recommended that regulation of the preliminary announcement was best carried out by the market regulator rather than by parliamentary legislation. The report did suggest that company law should require that the preliminary announcement be published on the company's website, with electronic notification to shareholders. However, that recommendation was not taken up in the Company Law Reform Bill of 2005. Instead the Bill included a general provision that companies may use electronic communication of documents providing the recipient agrees.

The content of the preliminary statement is influenced by guidance to listed companies, formerly provided by the Stock Exchange but transferred to the Financial Services Authority in 2000. The guidance leaves scope for flexibility in disclosure and measurement. That has caused the UK ASB to write non-mandatory guidance on good practice.

There is no obligation on companies to send these preliminary announcements to shareholders so that in practice only the institutional shareholders and their advisers see them. The ASB suggests that it would be fairer if all shareholders were entitled to request a copy of the announcement. Companies are also encouraged to use ways of publicising the preliminary announcements which will make them more readily available to the private investor.

Reliability is a key requirement of the preliminary announcement. The Stock Exchange requires the company's auditors to agree to the release of the preliminary announcement. There is an expectation that the information in the preliminary announcement will be consistent with the annual report when it eventually appears.

The rules of the Financial Services Authority and the Stock Exchange do not regulate the content of the preliminary announcement other than the requirement for profit and loss information and any significant information necessary for the purpose of assessing the results being announced. In practice many of these announcements include more information than the profit and loss account. The ASB recommends a narrative commentary, a summarised profit and loss account, a summarised balance sheet and a summarised cash flow statement. Increasingly it is found that companies are using the text of the Operating and Financial Review as the basis for the narrative comment in the preliminary announcement.

In general the ASB wishes to improve the timeliness, quality, relevance and consistency of preliminary announcements within the constraints of reliability. It could be that in the longer term the preliminary announcement would increasingly take over the role of the annual report. The delay in publishing the annual report is related to the need to publish a paper-based document. The Company Law Review report recommends that electronic means of communication could speed up the process considerably.

7.9.2 Interim reports

Interim reports are issued by companies as updating bulletins in between annual reports. They are mainly used by listed companies in response to the requirements of market regulators. Some market regulators ask for half-yearly reports. Others ask for quarterly reports. The international accounting standard IAS 34²¹ provides guidance on interim reporting.

One interesting accounting question is how to measure the results of half a year. One view is that the results of half a year should represent the actual events of that half-year. This is called the 'discrete' method. A different view is that the result for six months should represent half of the results of the full year. This is called the 'integral' method. Why does this make a difference? Imagine a company which manufactures and sells fireworks. The costs will fall evenly through the year but most of the sales will arise in the months leading to 5 November. Using the discrete method, the first six months of the calendar year will show low profits or perhaps losses. The second six months will show relatively high profits. Using the integral method each half-year will show the same profit at 50% of the total figure of the year.

IAS 34 requires the discrete method to be used as far as possible. Some expense items, such as taxation, may have to be spread evenly over the year.

In matters of disclosure the IASB recommends that the interim report should include a balance sheet, income statement, statement of changes in equity and cash flow, together with explanatory notes and comments.

Activity 7.7

Obtain the interim report and the annual report of a major listed company. Compare the interim report with the annual report. What are the information items in the interim report? How do they compare with the full year in the annual report? What statements of accounting policy are made in the interim report?

7.9.3 Prospectus

When a major company wants to raise significant amounts of finance through selling shares on the Stock Market, it issues a **prospectus**. The contents of the prospectus are regulated by the UK Listing Authority, backed up on some items by the Companies Act 1985. The document is often several hundred pages in length and quite formidable in appearance. It contains more detail than the annual report. The prospectus is a public document but there is no central archive of prospectuses so it is useful in research projects to retain copies as they appear. Some business libraries retain copies.

7.9.4 Small and medium-sized companies

The amount of detail in the information presented by companies depends on their size. The Companies Act 1985 defines small and medium-sized companies. The definitions are based on turnover, balance sheet totals and average number of employees. The amounts for turnover and balance sheet totals are altered from time to time by Statutory Instrument to keep pace with inflation, so it is perhaps easiest to take as a 'rule of thumb' the employee limits of 50 for a small company and 250 for a medium-sized company. For these companies there are substantial exemptions from requirements to publish information (although they must still provide details to shareholders if asked to do so). Generally they are not listed companies and so are not required to meet the obligations placed on listed companies. Most of these small and medium sized companies are likely to continue to present financial statements based on UK ASB standards and company law.

During the 1980s, concerns were expressed about the 'burden' of regulation for small companies. This burden was seen as falling from all directions, including tax laws, employment laws, product protection laws, health and safety laws and accounting regulation. The government of the time committed itself to reducing this burden. One consequence was that the UK Accounting Standards Board introduced a Financial Reporting Standard for Smaller Entities (FRSSE). This condenses into one standard the essential aspects of all the separate accounting standards for larger companies. It reduces disclosure requirements but maintains standards for measurement. Small companies may choose either to apply the FRSSE in full or to comply with the full range of separate standards.

The Companies Act 1985 permits small and medium-sized companies to file 'abbreviated' financial statements with the Registrar of Companies. The word 'abbreviated' can be explained as 'cutting down the detail' but views have been expressed that this has gone too far and that abbreviated financial statements do not provide useful information about small companies. It allows them, for example, to maintain confidentiality of profit margins. The White Paper of 2005²² acknowledged this concern but noted that the option was popular with many companies. It said that the Government intended to retain the option for abbreviated financial statements but would require small and medium sized companies to disclose revenue (turnover).

The 2005 White Paper contained a separate section covering small companies. These were defined as meeting two or more of the conditions: turnover not more than £5.6m, balance sheet total not more than £2.8m, employees not more than 50. Separate schedules were provided setting out items to be reported in the balance sheet and profit and loss account.

7.9.5 Avoiding information overload

Even the very largest companies may take advantage of the rule which allows them to publish summary financial statements. These are usually very much shorter than the full annual report and are offered to shareholders as an alternative to the full report. There is a short form of the balance sheet, profit and loss account and cash flow statement, no notes to the accounts but usually an accompanying commentary by the company directors. Shareholders are reminded of the existence of the full report and invited to ask for a copy if desired.

7.9.6 'Pro forma' financial statements

'Pro forma' financial statements represent a recent development in company reporting that is causing some confusion among users of accounting information, and some concern among the regulators. When companies first announce their profits of the

financial year, or the results of an interim period, they do so through an 'earnings announcement' at the Stock Exchange. This is accompanied by a press release which may draw investors' attention to a particular component of the financial statements. According to the dictionary, the phrase 'pro forma' means 'as a matter of form'. The underlying accounting meaning is 'outside the normal reporting regulations'. It usually involves selective editing from a larger body of information that has been prepared under accounting rules. The risk is that the selective information may not, by itself, represent a true and fair view. This does not necessarily mean that the information is bad or misleading, but it does mean that the investor is deprived of the full protection of regulation.

7.9.7 Electronic publication of documents

Chapter 4 (Section 4.5.2) explains the progress of a major review of company law in the UK. One conclusion of the Review was that the law allows financial reporting to be a slow process. The White Paper of March 2005 confirmed that a document supplied in electronic form would be validly delivered if that form had been agreed by the intended recipient (or the intended recipient had not replied when asked for a preference). However shareholders and others having a right to receive information would be able to ask for a paper copy of a document.

7.10 Summary

- Company law in the UK includes sections that implement EU Directives. This means that UK company accounting has for many years been harmonised with company accounting in other Member States of the EU, but mainly in matters of disclosure. Member states have continued to require or permit different measurement practices.
- From 2005 listed groups of companies in EU Member States have been required to follow the IASB system of reporting. Individual companies and unlisted groups have the choice of the IASB system or UK company law and UK ASB standards.
- The primary financial statements under both systems include a balance sheet, income statement (profit and loss account) and cash flow statement. Under the IASB system a statement of changes in equity is required. Under the UK ASB standards a statement of recognised gains and losses is required and a note of movements on reserves.
- Formats set out the content and layout of financial statements. Under UK company law there are detailed formats required for the balance sheet and profit and loss account. The IASB system is more flexible on layout but provides lists of essential items.
- A group of companies consists of a parent and subsidiaries. All must be included. A subsidiary is defined by the control exercised by the parent. Control is commonly evidenced by the parent holding more than half of the voting power in the subsidiary. Control may be evidenced in other kinds of agreements relating to shareholdings or to the board of directors.
- A consolidated balance sheet contains the total assets and liabilities of the group of companies, after eliminating any amounts receivable and payable between group companies.
- A consolidated income statement (profit and loss account) contains the total revenues and expenses of the group of companies, after eliminating any transactions and profits made between group companies.

- A consolidated cash flow statement contains the total cash flows of the group of companies, after eliminating any cash flows between group companies.
- Goodwill arising on acquisition is calculated by comparing the fair value of the payment for the subsidiary with the fair value of net assets acquired. It represents future economic benefits arising from assets that are not capable of being individually identified and separately recognised.
- Goodwill is recognised as an asset in the balance sheet and is tested annually for impairment.
- Beyond the annual report there is a range of corporate communications – often found most readily by visiting a company’s website.
- For small companies special disclosure rules apply to reduce the burden of providing information.

Further reading

IAS 1 (2004) *Presentation of financial statements*. International Accounting Standards Board. This is a detailed standard, some of which is beyond a first level course, but the examples of financial statements given in the Appendix show the types of presentation that companies might use or adapt.

IFRS 3 (2004) *Business combinations*. International Accounting Standards Board. (This is a very detailed standard which is beyond a first level course but the definitions in the Appendix may be useful in explaining terms encountered in financial statements.)

Useful websites

International Accounting Standards Board: www.iasb.org

UK Accounting Standards Board: www.asb.org.uk

London Stock Exchange: www.londonstockex.co.uk

Financial Services Authority: www.fsa.gov.uk

UK Company Law Review: www.dti.gov.uk

QUESTIONS

The Questions section of each chapter has three types of question. ‘Test your understanding’ questions to help you review your reading are in the ‘A’ series of questions. You will find the answers to these by reading and thinking about the material in the book. ‘Application’ questions to test your ability to apply technical skills are in the ‘B’ series of questions. Questions requiring you to show skills in problem solving and evaluation are in the ‘C’ series of questions. A letter [S] indicates that there is a solution at the end of the book.

A Test your understanding

- A7.1** What is a Directive? (Section 7.2.1)
- A7.2** What is the IAS Regulation? (Section 7.2.1)
- A7.3** What is the role of the IASB? (Section 7.2.2)
- A7.4** Name the primary financial statements and explain the purpose of each. (Section 7.3.1)

- A7.5** The following technical terms appear in this chapter. Check that you know the meaning of each. (If you cannot find them again in the text, they are defined at the end of the book.)
- (a) revenue
 - (b) capital
 - (c) non-current asset
 - (d) depreciation
 - (e) directors
 - (f) earnings for equity holders (ordinary shareholders)
 - (g) earnings per share
 - (h) external users (of financial statements)
 - (i) financial position
 - (j) gross
 - (k) gross margin
 - (l) gross profit
 - (m) net
 - (n) net assets
 - (o) primary financial statements
 - (p) reserves
 - (q) revaluation reserve
 - (r) share premium
 - (s) tangible fixed assets
 - (t) turnover.
- A7.6** How do companies report: (Section 7.3.1)
- (a) financial position;
 - (b) performance; and
 - (c) changes in financial position?
- A7.7** What are the main headings to be found in most company balance sheets? (Section 7.4)
- A7.8** In the Companies Act formats, what is the reason for the order of items under heading C: current assets? (Section 7.4)
- A7.9** What are the main headings to be found in most company income statements (profit and loss accounts)? (Section 7.5)
- A7.10** What are the main sections of a cash flow statement prepared according to IAS 7? (Section 7.6)
- A7.11** Why does depreciation appear as a line item in the reconciliation of operating profit with cash flow? (Section 7.6.3)
- A7.12** Explain why groups of companies are formed. (Section 7.7)
- A7.13** Explain the purpose of consolidated financial statements. (Section 7.7)
- A7.14** Define the terms: (Section 7.7.1)
- (a) group;
 - (b) parent company; and
 - (c) subsidiary.
- A7.15** Explain, using the accounting equation, the effect on the parent company's balance sheet of a cash payment for an investment in a subsidiary company. (Section 7.8.1)
- A7.16** Explain, using the accounting equation, the effect on the parent company's balance sheet of a share issue in exchange for shares in the subsidiary company. (Section 7.8.1)
- A7.17** Explain what is meant by goodwill on acquisition. (Section 7.8.4)
- A7.18** What is an associated company? (Section 7.8.5)

- A7.19** Apart from the annual report, what other documents do companies use to communicate financial statement information to investors, creditors and other users of financial statements? (Section 7.9)

B Application

B7.1 [S]

Write a letter to the financial controller of a company advising on the factors which a company should take into consideration when deciding how to arrange information in financial statements.

B7.2 [S]

Write a note for financial analysts explaining how the published income statement (profit and loss account) provides a useful indication of the financial performance of a company.

B7.3 [S]

What features are likely to make a balance sheet helpful to users?

B7.4 [S]

Could a cash flow statement be presented as the only financial statement reported by a company? Explain your view.

C Problem solving and evaluation

C7.1 [S]

A listed company is of the view that shareholders might welcome a statement of highlights and supplementary information as a leaflet to be inserted in the annual report. Give advice on the principles to be followed in making such information useful to users.

Activities for study groups

Continuing to use the annual reports of companies which you obtained for Chapters 1 and 4, find the financial statements (balance sheet, profit and loss account and cash flow statement) and the notes to the accounts.

- 1 Compare the financial statements with the formats and presentations shown in this chapter, and note any differences which you observe. Look at the notes to the accounts for items which are required by the regulations but are included in the notes rather than the main financial statements.
- 2 Find the Operating and Financial Review (sometimes named the finance director's review) and compare the cash flow discussion there with the FRS 1 presentation. Form a view on how readily the discussion may be related to the financial statement.
- 3 In your group, take the list of qualitative characteristics listed at section 4.2 and use the financial statements as a means of illustrating how the company has met those characteristics. If you have a set of different annual reports, each member of the group should take the role of a finance director pointing out the qualitative characteristics of their own company's financial statements. The group together should then decide on a ranking with a view to nominating one of the annual reports for an award of 'Communicator of the Year'.

Notes and references

1. IAS 1 (2003), *Presentation of Financial Statements*, para. 8.
2. IASB *Framework*, para. 12.
3. The Appendix to IAS 1 (2003) gives an illustration which is not compulsory.
4. The Appendix to IAS 1 (2003) gives an illustration which is not compulsory.
5. ASB (1996), Financial Reporting Standard (FRS 1), *Cash Flow Statements*, Accounting Standards Board (revised from 1991 version).
6. IASB (2004), IAS 7 *Cash flow statements*, para. 4.
7. IAS 7 (2004), para. 6.
8. IAS 7 (2004), para. 6.
9. ASB (1999), ch. 2, 'The reporting entity', Principles section.
10. IAS 27 (2004) *Consolidated and separate financial statements*, para. 4.
11. IAS 27 (2004), para. 4.
12. IAS 27 (2004), para. 4.
13. IAS 27 (2004), para. 4.
14. IAS 27 (2004), para. 12. A scope exclusion for temporary control, retained in the first 2003 version was removed by IFRS 5 issued in March 2004, see BC 14.
15. IAS 27 (2004), para. 4.
16. IAS 27 (2004), para. 13.
17. IFRS 3 (2004), para. 1 uses the description 'purchase method' but the exposure draft modifying IFRS 3, issued in 2005, uses the description 'acquisition method'.
18. IFRS 3 (2004), Appendix A.
19. IFRS 3 (2004), para. 51. In this section it is assumed in the explanations that fair value equals book value of net assets of subsidiary.
20. IAS 28 (2004), paras. 2 and 6.
21. IASB (2004), IAS 34 *Interim financial reporting*.
22. Company Law Reform, March 2005, Cm. 6456, DTI.

Supplement to Chapter 7.1

Information to be presented on the face of the Balance sheet, as required by IAS 1

Note that this is a list of items, not a format, so a company could choose to present the items in a different sequence.

There must be separate headings for current and non-current assets, and current and non-current liabilities.¹

As a minimum the face of the balance sheet must include the following line items:²

- (a) Property, plant and equipment
- (b) Investment property
- (c) Intangible assets
- (d) Financial assets
- (e) Investments accounted for using the equity method
- (f) Biological assets
- (g) Inventories
- (h) Trade and other receivables
- (i) Cash and cash equivalents
- (j) Trade and other payables
- (k) Provisions
- (l) Financial liabilities (excluding items shown under (j) and (k))
- (m) Liabilities and assets for current tax
- (n) Deferred tax assets and deferred tax liabilities
- (o) Minority interests within equity (ownership interest)
- (p) Issued capital and reserves attributable to equity holders of the parent.

An entity must disclose further sub-classifications of these line items, classified in a manner appropriate to the entity's operations. These further sub-classifications may be presented either on the face of the balance sheet or in notes.³

1. IAS 1 (2003), para. 51.

2. IAS 1 (2003), para. 68.

3. IAS 1 (2003), para. 74.

Supplement to Chapter 7.2

Balance sheet format 1, as prescribed by the Companies Act 1985

The Companies Act sets out the format as a list of items. The list attaches letters A to K to the main headings and uses roman numerals for subheadings of items which are important but slightly less important than the main headings. The headings labelled by letters A to K and the subheadings labelled by roman numerals must be shown in the main body of the balance sheet. There are further lists of detailed items which must be reported but which may be contained in additional pages of notes to the balance sheet. These lists are given arabic numerals to identify them. There is a general rule that where an item under any heading is not relevant to the company, or is of zero amount, it need not be disclosed. So if a company does not mention one of the items in the format, it has to be presumed that the particular item is not relevant to that company.

A Called-up share capital not paid

B Fixed assets

I Intangible assets

- 1 Development costs
- 2 Concessions, patents, licences, trade marks and similar rights and assets
- 3 Goodwill
- 4 Payments on account

II Tangible assets

- 1 Land and buildings
- 2 Plant and machinery
- 3 Fixtures, fittings, tools and equipment
- 4 Payments on account and assets in course of construction

III Investments

- 1 Shares in group undertakings
- 2 Loans to group undertakings
- 3 Participating interests (excluding group undertakings)
- 4 Loans to undertakings in which the company has a participating interest
- 5 Other investments other than loans
- 6 Other loans
- 7 Own shares

C Current assets

I Stocks

- 1 Raw materials and consumables
- 2 Work-in-progress
- 3 Finished goods and goods for resale
- 4 Payments on account

II Debtors

- 1 Trade debtors
- 2 Amounts owed by group undertakings
- 3 Amounts owed by undertakings in which the company has a participating interest
- 4 Other debtors
- 5 Called-up share capital not paid
- 6 Prepayments and accrued income

- III *Investments*
 - 1 Shares in group undertakings
 - 2 Own shares
 - 3 Other investments
- IV *Cash at bank and in hand*

D Prepayments and accrued income

E Creditors: amounts falling due within one year

- 1 Debenture loans
- 2 Bank loans and overdrafts
- 3 Payments received on account
- 4 Trade creditors
- 5 Bills of exchange payable
- 6 Amounts owed to group undertakings
- 7 Amounts owed to undertakings in which the company has a participating interest
- 8 Other creditors including taxation and social security
- 9 Accruals and deferred income

F Net current assets (liabilities)

G Total assets less current liabilities

H Creditors: amounts falling due after more than one year

- 1 Debenture loans
- 2 Bank loans and overdrafts
- 3 Payments received on account
- 4 Trade creditors
- 5 Bills of exchange payable
- 6 Amounts owed to group undertakings
- 7 Amounts owed to undertakings in which the company has a participating interest
- 8 Other creditors including taxation and social security
- 9 Accruals and deferred income

I Provisions for liabilities and charges

- 1 Pensions and similar obligations
- 2 Taxation, including deferred taxation
- 3 Other provisions

J Accruals and deferred income

Minority interests*

K Capital and reserves

- I *Called-up share capital*
- II *Share premium account*
- III *Revaluation reserve*
- IV *Other reserves*
 - 1 Capital redemption reserve
 - 2 Reserve for own shares
 - 3 Reserves provided by the articles of association
 - 4 Other reserves
- V *Profit and loss account*

Minority interests*

*Note: Where minority interests are relevant, they are to be treated as having a letter attached. Companies may choose one of the two permitted locations.

Supplement to Chapter 7.3

Information to be presented on the face of the Income Statement as required by IAS 1

As a minimum, the face of the income statement must include line items that present the following amounts for the period:⁴

- (a) revenue
- (b) finance costs
- (c) share of the profit or loss of associates and joint ventures accounted for using the equity method
- (d) tax expense
- (e) a single amount comprising the total of (i) the after-tax profit or loss of discontinued operations and (ii) the after-tax gain or loss recognised on disposal of the discontinued operation
- (f) profit or loss.

If there is a minority interest in a subsidiary (where the parent holds less than 100% of the share capital of the subsidiary) then the profit or loss attributable to the minority interest must be disclosed separately from the profit or loss attributable to equity shareholder in the parent.⁵

An entity must disclose additional line items, headings and subtotals on the face of the income statement when such presentation is relevant to an understanding of the entity's financial performance.⁶

4. IAS 1 (2003), para. 81.

5. IAS 1 (2003), para. 82.

6. IAS 1 (2003), para. 83.

Supplement to Chapter 7.4

UK Companies Act Profit and loss account format 1 – list of contents

- 1 Turnover
- 2 Cost of sales
- 3 Gross profit
- 4 Distribution costs
- 5 Administrative expenses
- 6 Other operating income
- 7 Income from shares in group undertakings
- 8 Income from participating interests (excluding group undertakings)
- 9 Income from other fixed asset investments
- 10 Other interest received and similar income
- 11 Amounts written off investments
- 12 Interest payable and similar charges
- 13 Tax on profit or loss of ordinary activities
- 14 Profit or loss on ordinary activities after taxation
- 15 Extraordinary income
- 16 Extraordinary charges
- 17 Extraordinary profit or loss
- 18 Tax on extraordinary profit or loss
- 19 Other taxes not shown under the above items
- 20 Profit or loss for the financial year