# Chapter 6 revision notes

## Published reports and accounts

**Information included in annual reports and accounts**

The type of information, both financial and non-financial, that is reported in company annual reports and accounts includes:

- chairman's statement
- chief executive's statement
- financial review
- accounting policies
- financial highlights
- financial statements
- notes on the accounts
- environmental report
- directors' report
- corporate governance report
- report of the auditors

**Why are annual accounts filed and published?**

Limited companies prepare their annual reports and accounts to keep shareholders informed about financial performance and the financial position of the business.

The annual report and accounts of a public limited company now requires disclosure of a great deal of both financial and non-financial information in addition to the financial statements, and allows evaluation of a public limited company in a wider context than was latterly possible from the sort of financial information traditionally required by the shareholders.

Copies of the annual report and accounts must be filed with the Registrar of Companies, and presented for approval by the shareholders at the company's annual general meeting (AGM). Further copies are usuall made available to other interested parties such as financial institutions, major suppliers and other investors.

Large companies also issue half yearly, or interim reports that include the standard financial information, but the whole report is on a much smaller scale than the annual report.

In 1993 the Accounting Standards Board (ASB) issued a statement of good practice that supported the earlier suggestion made in the report of the Cadbury Committee (1992) that companies should include in their annual reports an operating and financial review (OFR) of the business. The reason for this suggestion was that businesses had become increasingly diversified and complex, and it had become increasingly difficult to understand information contained in financial reporting. Complex financial and organisational structures made it difficult to analyse and interpret financial information. It was felt that the OFR was needed to provide a greater insight into the affairs of the company, in addition to the information traditionally already provided by the chairman's statement and the directors' report.

The OFR was intended to cover the business as a whole for the year under review, and to include issues relevant to the assessment of future prospects. The OFR should include:

- brief reports that are easy to understand
- reports on each of the individual aspect of the business
- explanations of non-recurring aspects of the business
- discussion of matters that underpin the financial results for the period
- consideration of factors that might impact on the future performance of the business

The OFR includes two separate reports:

- an operating review, usually provided by the chief executive, which includes:
  - new product development information
  - details of shareholders' returns

- sensitivities of the financial results to specific accounting policies
  - risks and uncertainties
  - future investment
- a financial review, usually provided by the finance director, which includes:
  - current cash position
  - sources of funding
  - treasury policy
  - capital structure
  - confirmation that the business is a going concer
  - factors outside the balance sheet impacting on the value of the business
  - taxation

**Chairman's statement**
This offers an opportunity for the chairman of the company to report in unquantified and unaudited terms on the performance of the company during the past financial period and on likely future developments.

**Chief executive's statement**
Chief executives' statements generally include detail on the performance of the business particularly relating to products, markets, technology and the various geographical areas of activity. These statements include brief comments on the financial highlights of the preceding year and the recommended dividend payable to shareholders. The chief executive's statement includes the operating review that outlines the main factors that underlie the business and identifies any changes or expected future changes that may impact on the business. It normally concludes with an outlook on the future prospects of the business.

**Financial review**
The financial review goes into further financial detail than the chief executive's statement and is normally prepared by the finance director. The purpose of the financial review is to review the results for the past year and to provide an overview of financial policy.

**Accounting policies**
The statement of accounting policies informs readers of the policies the company has pursued in preparation of the report and accounts, and of any deviation from the generally accepted fundamental accounting concepts and conventions.

**Financial highlights**
The section headed financial highlights serves to focus on the headline numbers of sales, profit before tax, earnings per share, dividends, and return on investment.

**Profit and loss account, balance sheet, and cash flow statement**
For groups of companies the profit and loss account is consolidated to include the results of all the companies within the group. Profit is stated both before exceptional items and after exceptional items, and the consolidated profit and loss account also shows prior year comparative figures.
The balance sheet is presented in consolidated form, also showing prior year comparative figures, and includes a separate balance sheet for the parent company only.
The cash flow statement is consolidated to include the cash flows of all the companies within the group, and includes the parent company.

**Horizontal analysis**
Horizontal analysis of the profit and loss account (which may also be applied to the balance sheet) for two or more years is an analytical tool that starts with a base year 100 and shows each item, line-by-line, indexed against the base year, and is particularly useful in looking at performance trends over a number of years.
This technique is particularly useful to make a line-by-line comparison of a company's accounts for each accounting period over say five or ten years, using the first year as the base year. Presentation of the

information in this way, in tabular form, for a number of years, gives a very clear picture of trends in performance in each area of activity and may provide the basis for further analysis.

**Vertical analysis**

Vertical analysis of the profit and loss account (which may also be applied to the balance sheet) is another analytical tool that shows every item as a percentage of turnover (balance sheet – total assets), and is also particularly useful in looking at performance trends over a number of years.

**Notes on the accounts**

The section headed Notes on the Accounts in the annual report and accounts contains information that must be reported additional to, and in support of, the financial statements. This may be used to comment on financial performance. Generally, the information disclosed in notes to the accounts includes:

- segmental information – analysis by business and geographical area relating to turnover, operating profit and net assets
- exceptional items
- discontinued operations
- operating profit
- net interest
- profit before taxation
- taxation
- earnings per share
- dividends
- employees/directors information – employee numbers, costs, and retirement benefits
- fixed assets
- stocks
- debtors
- investments
- borrowings
- derivatives and financial instruments
- creditors
- finance leases
- provisions
- share capital
- reserves
- commitments and contingent liabilities
- cash flows
- net debt
- acquisitions and disposals
- post balance sheet events

**Segmental reporting**

Segmental reporting provides a further dimension to the financial statements through analysis of turnover, operating profit and net assets, by business class and geographical segments. Most large companies are usually comprised of diverse businesses, rather than being engaged in a single type of business activity, that supply different products and services. Each type of business activity may have:

- a different structure
- different levels of profitabilit
- different levels of growth potential
- different levels of risk exposure

Segmental reporting analysis enables:

- the further analysis of segmental performance to determine more accurately the likely growth prospects for the business as a whole

- evaluation of the impact on the company of changes in conditions relating to particular activities
- improvements in internal management performance, because it may be monitored through disclosure of segmental information to shareholders
- evaluation of the acquisition and disposal performance of the compan

Class of business is a part of the overall business, which can be identified as providing a separate product or service, or group of related products or services. A geographical segment may comprise an individual country or a group of countries in which the business operates.

There are many general problems relating to the principle of disclosure of segmental information, and som accounting problems concerned with the preparation of segmental reports.

**Environmental reporting**

Throughout the past ten years or so companies have started to show greater interest about their position with regard to environmental issues. General corporate awareness has increased as to how the adoption of particular policies may have adverse social and environmental effects.

The increase in awareness of environmental and social issues has followed the concern that the focus of traditional reporting has been weighted too heavily towards the requirements of shareholders, with too little regard to the other stakeholders. This has led to an over-emphasis on the financial performance, particularly the profitability, of the business. The quality and depth of environmental and social reporting, in both qualitative and quantitative terms, is becoming increasingly important as annual reports and accounts are required to meet the needs of all stakeholders, not just the shareholders.

There is currently no consensus of 'best practice' in the area of social and environmental reporting. Neither is there a compulsory requirement for companies to include such statements in their annual reports and accounts. However, most large companies have reacted positively to the need for such reporting, although the quality, style and content, and the motives for inclusion, vary greatly. Motives may range from simple reassurance to attempts to mould and change opinion, and political lobbying.

Few companies yet provide detailed quantitative reports of targets, and performance and the financial impact of environmental issues.

**Directors' report**

The directors' report includes financial and non-financial information, and it is a statutory requirement for a copy of this report along with the accounts of the business to be sent to shareholders. The directors' report includes a great deal of detail, for example:

- details of the principal activities of the business
- information about directors and their share ownership
- details about auditors
- company employment policy
- proposed dividends payable to shareholders
- major fixed assets acquisitions and disposals, and changes in valuation
- changes to share capital
- charitable and political donations made by the compan

Following the publication of the Cadbury Committee report in 1992, the directors' report now includes a section on corporate governance, and includes details about the company's system of internal control, and its various committees.

**Inflation and reporting**

Although the financial statements of limited companies are not adjusted for the effects of inflation the impact of inflation is a factor that must be considered in evaluation of business performance.

Inflation is a general increase in the price level over time. The accountancy profession has, over the years, considered many proposals of methods to try and deal with inflation-related problems requiring financial reports to reflect the effects of inflation.

The basic problem of inflation in financial reporting is that it tends to overstate profit calculated using traditional historical costs. In periods of inflation the impact on profit is seen in four key areas:

- borrowing and extended credit received are worth less in real terms when settled compared to when the borrowing took place or the credit was received, which is a gain for the business

- financial investments made and extended credit allowed are worth less in real terms when settled compared to when the investments took place or the credit was granted, which is a loss for the business
- depreciation of fixed assets is understated, being based on fixed assets' historical costs and so when assets eventually have to be replaced the replacement cost will be higher, for which the company may have provided insufficient cash resources
- closing stocks will be more likely to have higher values, on a like-for-like basis, compared with opening stocks and so profit may be overstated, but the pressure on cash resources will be felt when stocks have been sold and then need to be replaced at higher prices

It is important for the non-accounting specialist to be aware that the published financial statements of UK limited companies have not been adjusted to allow for the effects of inflation.

## Value added statements

The value added statement, which is an alternative presentation of the traditional profit and loss statement, measures wealth as the value added by the business rather than the profit earned by the business. The value added statement is effectively a rearrangement of the profit and loss account. It shows how value added is distributed among the relevant parties:

- employees
- lenders
- shareholders
- Government

and the amount to provide maintenance and expansion of the business.

The value added statement has a number of advantages and disadvantages as a business performance measure. It is unlikely to replace the conventional profit and loss account, or cash flow statement as a decision-making tool or as a measure of business performance. However, it may continue to be useful for internal communication of company financial performance to employees, and in support of employee incentive schemes.