Financial Reporting Assignment

Subject – Legal and Regulatory Influence on the Production and Presentation of Financial Statements

Report to Dave Belton 16th December 2003

Purpose of Report

The purpose of this report is to explain the legal and regulatory influences on the production and presentation of financial statements and assess the implications of such policies and concepts for users of financial statements and final account. The report will demonstrate the effect that different policies have on the final accounts.

Introduction

All business's have to meet internal and external reporting requirements to show their financial wellbeing and satisfy the legal standards. In order to make judgements about business we require accounting information. Accounting is concerned with identifying, measuring, recording and reporting information relating to the activities of an organisation. Due to the competitive nature of all business accounting information has to be reliable, comparable, relevant and understandable. These are the basis on which business's stakeholders scan make decisions.

This financial information includes any information on activities within a business that are expressed in some form of monetary term. The financial information will expose whether the business makes efficient use of resources to provide the desired financial return, whether the business has the ability to generate cash to ensure continued trading and to make dividend payments and this info will also declare the nature of business's assets and liabilities. The business's financial structure and prospects will also be let known, which is essential to owners and shareholders.

Financial sphere of influence is colossal it will determine its own employees future, advisors/brokers in advising their clients, the business's ability to make repayment to lenders, customer relations, community interest, competitors own decision making, suppliers concerns and of course government agencies such as the inland revenue concerns on payments to employees and subcontractors as well as taxes on level of business profits. These financial returns also form the assemblage of economic statistics.

Reporting Requirements

UK regulations influencing financial reporting of companies are derived form two sources which are government legislation and accounting standards.

Government legislation originates mainly from the Companies Act 1985. This act lays down the requirements concerning financial statements prepared by limited companies. The main body of accountancy the Institute of Chartered Accountants in England and Wales members are under obligation to use best accountancy practice in the preparation of all accounts intended to give a true and reasonable view of a business's trading performance and financial outlook.

The result being that the information is required within ten months of the end of an accounting period for a private limited company. This comes in the form of a balance sheet, a profit and loss account, a cash flow statement (See Appendices A,B,C), notes to the accounts describing the company's accounting policies as well as the examination of certain items contained in the financial reports and finally the auditor's report confirming that the company's financial reports are reliable with the

company’s trading records and they make available a true and fair view of its trading performance plus its financial dealings. The only problem this creates, as with most legislation, is that it makes it tougher for small business to meet their business aims.

In respect of the other source Accounting Standards have been issued by the Accounting Standards Board. The first being in 1970 where s Statement of Standard Accounting Practice was introduced with the objection of limiting the ability of accountants to use varied accounting procedures. Basically this was introduced to provide consistency within the way accounts were produced and presented. These SSAPS were produced by the Accounting Standards Committee but in 1990 were taken over by the Accounting Standards Board. The ASB went about introducing Financial Reporting Statements again these were created with the idea to apply the best accounting practices to accounting statements of which members of the professional accounting bodies were obliged to do.

SSAP 2

The Companies Act 1985 detailed that certain basic concepts should be applied when preparing a set of financial reports. SSAP 2 was to provide the guidance on its purpose. SSAP 2 can be summed up as "It is fundamental to the understanding and interpretation of financial statements that those who use them should be aware of the main assumptions on which they are based." The Standard therefore sets out "to improve the quality of information disclosed" by ensuring that the principle accounting policies adopted in drawing up a set of accounts are clearly explained in the notes to those accounts.

The terms used in the Standard are classified into three tiers:

a) 'going concern' – this is the assumption that the business will continue to trade for the foreseeable future, and so assets are valued at historic cost, less depreciation if applicable, rather than at their forced sale value at the accounting date.
b) 'accruals' - determines when transactions should be entered in the accounts. Revenue and costs are recognised as they are earned or incurred rather than as money is received or paid.
c) 'consistency' - there should be consistency of accounting treatment of like items each year and from one year to the next.
d) 'prudence' - controls when items can appear in the Profit and Loss Account. Income and profits should not be anticipated. They should be included in the accounts only when realised in cash or other real assets. However, liabilities should be included, at least as an estimate, as soon as they are known with reasonable certainty.

An obvious question that originally arose was how the SSAP 2 concepts related to the underlying characteristics identified in the Statement of Principles. Accounting has developed significantly in the period since SSAP 2 was issued almost 30 years ago. In particular, it became apparent that two of the fundamental accounting concepts identified in SSAP 2 needed to be reviewed.

The concept of consistency implies that a company should rarely if ever change the way in which financial information is prepared and presented. The Statement of Principles regards comparability as a more important characteristic than consistency. Although comparability will often be achieved through consistency there will be occasions where a change in the method of preparing or presenting financial information gives a more useful picture to the user. The concept of prudence implies that a company should take a very negative outlook in estimating

income, expenses, assets and liabilities. Which is its own is not the most appropriate way to look at business's financial position.

Financial Reporting Standards

FRS1

FRS 1 requires reporting entity within preparing a cash flow statement in the manner set out in the FRS. Cash flows (See appendix C) are increases or decreases in amounts of cash revolving within the business. A cash flow should show the operating activities, returns on investments and servicing of finance, taxation, capital expenditure and financial investment, acquisitions and disposals, equity dividends paid management of liquid resources and financing.

When introduced this represented a radical change in financial reporting. However, cash flow statements had increasingly come to be recognised as a useful addition to the balance sheet and profit and loss account in their portrayal of financial position, performance and financial adaptability (in particular in indicating the relationship between profitability and cash-generating ability) and thus of the quality of the profit earned.

FRS 2

FRS 2 sets out the conditions under which an entity qualifies as a parent undertaking which should prepare consolidated financial statements for its group- the parent and its subsidiaries. In general an investor that controls an investor entity is its parent and should account for that entity as a subsidiary. The FRS also sets out the manner in which consolidated financial statements are to be prepared.

In the Companies Act 1985 introduced provisions dealing with parents and subsidiaries and group accounts—in particular looking at defining parent and subsidiary undertakings and content of group accounts. To keep the standard consistent large parts of the FRS are based on the act. The need to revise the earlier standard on group accounts arose because of the amendment of the Companies Act in 1989. However, the opportunity was to taken to conduct a thorough review of consolidated financial statements at the same time.

FRS 3

FRS 3 "Reporting Financial Performance" is the lynchpin of UK accounting standards. It defines the basic components of financial statements and sets out how they should be presented. The underlying principle behind FRS 3 was to shift the emphasis away from condensing financial performance reports down to a single "end result. This new approach gave birth to the Statement of Total Recognised Gains and Losses. The ASB viewed the STRGL as a primary statement of performance to rank alongside the profit and loss account, balance sheet and cash flow statement.

The ASB explained that if financial statements stopped at the P&L account, they would not reflect gains and losses such as asset revaluations that affect shareholders' funds, but are required by Company Law and other accounting standards to be taken directly to reserves. The STRGL tells shareholders about these incidentals, but opened the board to charges that it had created a loophole for people to bring gains in reserves back into the P&L account at a later date. The STRGL seemed to threaten the clarity of the P&L account, therefore changes were to be made.

FRS 3 stipulated that the P&L should be set out in a layered format to the following components of financial performance by results of continuing operations (including the results of acquisitions), results of discontinued operations, profits or losses on the sale or termination of an operation, costs of a fundamental reorganisation or restructuring and profits or losses on the disposal of fixed assets; and extraordinary items.

Turnover and operating profit are the minimum level of disclosure required in the P&L for continuing operations, acquisitions and discontinued operations. FRS 3 effectively stamped out the use of extraordinary items within UK accounts. The standard also changed the way exceptional items are presented. Rather than being aggregated in the P&L under one heading, exceptional are now included under the statutory headings to which they relate.

FRS 3 also laid the foundation for the increasing use of market value rather than historical cost as the basis for dealing with asset revaluations in the P&L. The standard includes the formulation for a "note of historical cost profits and losses" as a memorandum item. Where the entity has revalued assets, the note gives an abbreviated restatement of the P&L showing how it would appear if there had been no revaluation. The note should be presented immediately following the profit and loss account or the statement of total recognised gains and losses and is required whenever there is a material difference between the result as disclosed in the profit and loss account and the result on an unmodified historical cost basis; the point being to give a more comparable basis with those of entities that have not reported revaluations.

SSAP 9

SSAP 9 gives guidance on the accounting treatment of both stocks (inventories) and long-term contracts. The determination of profit for an accounting period involves the allocation of costs to reporting periods. As part of this process, the cost of unsold or unconsumed stocks is—to the extent that it is believed to be recoverable—carried forward until the period in which the stock is sold or consumed. Stock valuing methods FIFO, LIFO and AVLO (See appendix D) are classic examples of where finance profits can be over or under stated. According to the LIFO method there will be a lower stock valuation thus providing a lower profit figure. But SSSAP 9 stamped out this method being used. The principles that need to be adopted require stock to be fairly valued thus providing sound methods for valuation of stock i.e. AVLO.

Separate consideration needs to be given to long-term contracts. Owing to the length of time taken to complete such contracts, to defer recording turnover and taking profit into account until completion may result in the profit and loss account (income statement) reflecting not so much a fair view of the results of the activity of the company during the period but rather the results relating to contracts that have been completed in the period. It is therefore appropriate to take credit for ascertainable turnover and profit while contracts are in progress in accordance with the guidance given in SSAP 9.

SSAP 5

SSAP 5 seeks to achieve uniformity of accounting treatment of value added tax (VAT) in financial statements. In the UK and the Republic of Ireland, VAT is a tax on the supply of goods and services that is eventually borne by the final consumer but collected at each stage of the production and distribution chain. As a general principle, therefore, the treatment of VAT in the accounts of a trader should reflect

his role as a collector of the tax and VAT should not be included in income or in expenditure whether of a capital or revenue nature. There will, however, be circumstances in which a trader will bear the VAT, and in such cases where the VAT is irrecoverable, it should be included in the cost of the items reported in the financial statements.

Conclusion

When producing financial statements the legal and regulatory influences are vast, this report providing information only on a few of these. There importance is not to be underestimated and companies should be fully aware of there implications. The key concepts described in SSAP 2, FRS 1 , 2&3, SSAP 9 and SSAP form the ideal way in which financial information should be presented and produced. We live in a rapidly changing business world, keeping up to date may be very companies short fall. The way accounts are produced and presented will surely provide short cuts and stop gaps for companies to not provide an accurate overview of their financial position but with methods ever being produced to ensure a fair reflection of companies' financial position can be only beneficial. Fair accounts make the way foreword for financial interpretation, analysis and business decision making.

This report illustrates that producing financial statements are extremely relevant even in today's markets. This report will hopefully suggest that financial accounting provides investors with as much information as possible which is better than that obtained from other sources. Accuracy when producing and presenting financial statement bears the expectations based on management releases and decisions. These control mechanisms as explained in this report in all leads to the review of past management actions.