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Doing Business in the United Kingdom

PART IV FORMS OF BUSINESS
CHAPTER 21 Business Accounting

2-21 Doing Business in the United Kingdom § 21.03

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§ 21.03 Form and Content of Statutory Company Financial Statements

The format of a company's statutory financial statements is laid down in the CA 1985, which also contains detailed accounting rules and provides for accounting standards with which the statutory financial statements must comply. The present standard setting body, the Accounting Standards Board (ASB), took over responsibility from its predecessor the Accounting Standards Committee (ASC) in 1990. Thus far, 20 Financial Reporting Standards (FRSs) have been published by the ASB which has stated as its aims the establishment and improvement of standards of financial accounting and reporting for the benefit of users, preparers and auditors of financial information. Thus, the emphasis is on financial communication rather than on narrow financial reporting and this should be reflected in more coherent, logical and informative financial statements which will be more accessible to, and more easily understood by, the various users. To this end, the ASB has developed a Statement of Principles for Financial Reporting, which provides a fully integrated conceptual framework for the consistent and logical formulation of individual accounting standards.

At present, certain classes of company are exempt from some of the existing requirements, in particular small and medium-sized companies, dormant companies, and banking and insurance companies.n1 In addition, companies engaged in special categories of business, eg financial services, may be subject to separate statutory regulations which may include a requirement to make returns including additional or different information. This pattern of the emergence of separate tiers of reporting looks set to continue with the moves to deregulate smaller sized companies and to differentiate, in the setting of accounting standards, between standards appropriate to large companies and those suitable for smaller entities.

This chapter deals with accounting and reporting requirements as at June 2002. However, this chapter would not be complete without some reference to the major changes to these requirements, which are expected to occur over the next four years or so.

In June 2002, the European Commission issued a Regulation.n2 that requires all EU listed companies to prepare and publish consolidated financial statements in accordance with International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS), issued by the International Accounting Standards Board (IASB), from financial years commencing on or after 1 January 2005. For the consolidated financial statements of listed

companies, the Regulation will override, where necessary, national laws. Changes to the Companies Act 1985 will be necessary if unlisted companies are to adopt IFRSs and to make other consequential amendments. The Department of Trade and Industry (DTI) will issue, in the second half of 2002, a consultation document on proposed changes to the law and the application of IFRSs to other UK companies.

The ASB has started a project to converge UK GAAP with international standards by 2005. The first major step in this project happened on 15 May 2002 when it published seven Exposure Drafts and one Consultation Paper. These contain principally the twelve Exposure Drafts of revised international accounting standards also released on 15 May by the IASB.

[1] Overriding Principle and Format of Financial Statements

[a] Financial Statements Must Present a True and Fair View. The overriding requirement to be satisfied by company financial statements is that they must give a true and fair view of the state of affairs of the company as at the end of the reporting period and of its profit or loss for that period. To show a true and fair view it is normally necessary for financial statements to comply both with the detailed requirements as to form and content set out in Schedules 4, 4A and 5 to the CA 1985 and with applicable accounting standards. There are, however, dispensations for non-compliance with either legal requirements or accounting standards where this departure is necessary to ensure that the financial statements present a true and fair view. In these circumstances, which are sometimes termed 'true and fair overrides,' additional disclosures are required to explain the nature, reasons for, and effect of the departure.

[b] Prescribed Format of Financial Statements. The formats for the balance sheet and profit and loss accountn3 are laid down in Part I of Schedule 4 to the CA 1985; additional regulations for the format of the profit and loss account are contained in FRS3, for the balance sheet in FRS4 and for the cash flow statement in FRS1. There are two possible formats for the balance sheet and four possible formats for the profit and loss account.n4 Once a company has adopted a particular format it must continue to use that unless, in the opinion of the directors, there are special reasons for any change which must be disclosed and fully explained.

The formats detailed in the Act are effectively minimum requirements and a company may include additional detail or items if it so wishes. The formats contain three categories of headings or sub-headings designated, for identification purposes, in the Schedule by capital letters, roman numerals and arabic numerals. Headings and sub-headings designated by arabic numerals may be re-arranged in any instance where required by the special nature of a company's business; additionally, such headings and sub-headings may be combined if either their individual amounts are not material to understanding the accounts, or such combination is an aid to understanding (in this case full disclosure of the individual amounts must be given in the notes to the accounts). It should be noted that it is not permissible to set-off amounts in respect of items representing assets or income against amounts in respect of items representing liabilities or expenditure. Items for which the amount is not material to an understanding of the accounts may be omitted; it is however a requirement of the Act that comparative amounts are given for the previous financial year. Consequently, although an item may be immaterial in one year, it may not be omitted unless it was also immaterial in the previous year.

Schedule 4 requires that certain accounting principles and rules be followed in drawing up the accounts, that additional information be supplied either in the main body of the accounts or by way of note and imposes additional requirements where the company is a parent company or subsidiary undertaking or an investment company. It should be noted that certain treatments permitted under the Act are not in accordance with accounting standards. In these circumstances accounting standards should normally be followed.

[2] Content of the Balance Sheet

[a] Fixed Assets. The formats require the division of assets into fixed assets and current assets. Fixed assets comprise intangible assets, tangible assets and long term investments, while current assets include stock, debtors and

investments of a short-term nature. For the purposes of Schedule 4, assets of a company are taken to be fixed assets if they are intended for use on a continuing basis in a company's business and any assets not intended for such use are taken to be current assets.n5

The value at which fixed assets are included in the accounts may be determined on the historical cost basis or, depending on the type of asset, the current cost or market value basis. If the historical cost basis is used, the amount at which fixed assets are included in the accounts must be based on their purchase price or their production cost. Development costs may be included in the balance sheet only in special circumstances which are laid out in SSAP13. Where development costs are capitalised, the following information must be given in a note to the accounts:

-- the period over which the amount of those costs originally capitalised is being, or is to be, written-off; and

-- the reasons for capitalising the development costs in question.n6

Amounts representing goodwill may be included only to the extent that the goodwill has been purchased for valuable consideration; internally generated goodwill may not be recognised. Goodwill which has been recognised in the accounts must either be written off directly to reserves, or capitalised and amortised over a period chosen by the directors of the company not exceeding its useful economic life. FRS10, which deals with goodwill and intangible assets, does not permit a choice in the treatment of goodwill arising from 1998 onwards and requires that it be capitalised.

Any fixed asset which has a limited useful economic life must be depreciated systematically over the estimated period of that useful economic life. This is to reduce the value of the asset to its estimated residual value at the end of its useful economic life in such a way that the benefits accruing from the asset are matched with the costs of owning the asset and of replacing it once its useful economic life has expired. In practice, depreciation must be charged on virtually every fixed asset (there are, however, special rules for investment properties).n7 Inevitably, many estimates of a fixed asset's useful economic life may need to be revised from time to time. The carrying values of all fixed assets should be considered at the end of each accounting period to ensure that they are in fact fair. If a fixed asset has experienced a permanent diminution in value, the CA 1985 requires provision to be made for that diminution in value, regardless of the remaining estimated useful economic life of the asset. FRS11 then imposes a tougher test than the CA 1985. Most fixed assets have to be tested, where necessary, for impairment, so that they are not included in balance sheets at values higher than their recoverable amounts Fixed assets must be depreciated irrespective of the cost convention under which they are included in the accounts.

The balance sheet formats define a number of different categories of fixed asset. Whilst it is the total 'net book value' (cost less cumulative provisions for depreciation) of the fixed asset which is the figure contained on the face of the balance sheet, the notes to the accounts must contain a number of additional disclosures. For each of the categories of fixed asset identified, the following must be disclosed at cost:

-- acquisitions;

-- disposals;

-- transfers to or from the relevant category; and

-- the effect of any revaluations.

The cumulative provisions for depreciation or diminution in value, the amounts provided during the financial year and the amount of any adjustment made to any provision as a result of any disposal of fixed assets must also be disclosed for each of the categories.

The amounts attributable to freehold and leasehold properties must be disclosed separately and, in the case of leasehold properties, the amounts attributable to long leases (ie leases with an unexpired term of fifty years or more) and short leases must also be shown separately. Where any fixed assets of the company (other than listed investments) are included in the balance sheet at a valuation, then details of the date and the basis of valuation and the professional qualifications of the valuers must be given. FRS15 has imposed tougher rules on revaluation of fixed assets. Companies cannot revalue now only selective assets: they must revalue all assets in a class. Futhermore, if a policy of revaluation is adopted, companies have to reconsider annually those valuations.

If the market value of the company's freehold or leasehold land at the year end differs from the amount which is included in the balance sheet by an amount which is, in the opinion of the directors, significant, then they are required to draw attention to this in the directors' report.n8 Investments which are held as fixed assets, that is investments which are being held for the long term, may be valued either under the historical cost convention or at a valuation. If the historical cost convention is chosen and this differs materially from the current cost of such investment, then the difference between the two amounts must be stated in the accounts. Disclosure must be made, either on the face of the balance sheet or in the notes to the accounts, of the amounts attributable to listed and unlisted investments and the average market value of listed investments must also be disclosed.

If the company includes in its investments at the balance sheet date a holding of 20% or more in an undertaking (other than a subsidiary undertaking) the CA 1985n9 requires the following additional disclosures:

-- the name of the undertaking;

-- if incorporated outside Great Britain, the country of incorporation;

-- if unincorporated the address of its principal place of business;

-- the identity of each class of shares in the undertaking held by the company; and

-- the proportion of the nominal value of the shares of that class represented by those shares.

These disclosures are also required if the carrying amount of the investment in the undertaking exceeds 20% of the amount shown for all the reporting company's assets.

Where a company has an interest of 20% or more in an undertaking (other than a subsidiary undertaking), then in addition to the disclosures detailed above, the aggregate amount of the capital and reserves of the undertaking at the end of its relevant financial yearn10 and its profit or loss for that year must be stated. This additional information need not be given if the company is a parent company included in the financial statements of a larger group and is therefore exempt from the requirement of group financial statements and if the investment of the company in all undertakings in which it has such a holding is shown in aggregate in the notes to the accounts by way of the equity method of valuation. Alternatively, the additional information need not be given if the undertaking in question is not required to deliver a copy of its accounts for the relevant financial year and the company's holding is less than 50% of the shares in the undertaking.

[b] Current Assets. Current assets consist of stocks (inventory), debtors (receivables), short term investments and cash. Current assets must be stated in the accounts at the lower of cost and net realisable value. Debtors are shown net of any provisions for bad debts and the amounts of such provisions do not need to be specified. Debts which fall due in greater than one year from the balance sheet date must be shown separately. The rules regarding accounting for current asset investments are substantially the same as those relating to fixed asset investments; however, under the alternative accounting rules (*see* [d] below) certain current asset investments may be stated at their current cost. This practice is known as 'marking to market.'

[c] Valuation. Under the Historical Cost Convention assets and liabilities are generally stated at original cost subject to depreciation and provisions for diminution in value. Original cost would generally be either the purchase price of the item or the production cost. The production cost of an asset may include the raw material and direct costs and a reasonable proportion of the indirect costs attributable to production, to the extent that they relate to the period of production. Interest on capital borrowed to finance production may be included to the same extent; however, the amount of such interest must be disclosed by way of a note.

Schedule 4 permits the use of various methods of stock valuation, which may be applied to other assets which are substantially indistinguishable from one another, for instance, investments. The methods listed as permissible by Schedule 4 are as follows:

-- first in first out (FIFO);

-- last in first out (LIFO);

-- weighted average; and

-- any other method similar to any of the above methods.

It should be noted that LIFO is not considered an acceptable accounting practice under SSAP9 which deals with stock and long term contracts.

[d] Alternative Accounting Rules. Under the Alternative Accounting Rules,n11 tangible fixed assets may be stated at their market value on the day that they were last valued, or at their current cost, rather than at historical cost. FRS15 on tangible fixed assets requires that where a tangible fixed asset is revalued all tangible fixed assets of the same class should be revalued.n12 By law, any surplus on a revaluation, calculated after provision for depreciation and diminution in value, must be transferred to a separate non-distributable reserve shown on the balance sheet and should not be included in the profit and loss account. This non-distributable reserve is generally known as the revaluation reserve.

[e] Creditors. In each of the prescribed formats, amounts falling due within one year must be shown separately from those falling due after more than one year. Long term indebtedness, ie, debts falling due for payment in whole or in part more than five years after the balance sheet date, must be disclosed either in the accounts or by way of note, and details given of the terms of payment and the rate of interest, if any, payable on the debt.n13 Where any security has been given for a debt, details must be disclosed. Long term liabilities must also be separated, on the face of the balance sheet, into convertible and non-convertible components. Where a company has issued debentures, various other items of information must also be given.n14

[f] Provisions. In the context of the statutory format, the term 'provision' means any amount retained as reasonably necessary to provide for any liability or loss which is either likely or certain to be incurred but uncertain as to the amount or as to the date on which it will arise. This does not, however, include provision for depreciation or diminution in the value of assets, the amount of which would be deducted from the amount of the asset in question. The statutory category 'provision for liabilities and charges' contains three sub-categories comprising provision for pensions and similar obligations, provision for taxation including deferred taxation and 'other provisions'. Any provision included in the last sub-category, which is material in amount, must be detailed either in the accounts or in the notes to the accounts. Details of movements in provisions during the financial year should also be disclosed.n15 Any contingent liabilities or material financial commitment not provided for must be disclosed either in the accounts or the notes.n16 Further rules on provisions are imposed by FRS12.

[g] Capital and Reserves. A company's called-up share capital and reserves must be shown separately in the balance sheet. Additionally, disclosure, which may be made in the notes to the balance sheet, is required of the amount

of authorised share capital, the number and aggregate nominal value of the shares of each class allotted and details of any shares allotted in the financial year. Where a company has redeemable shares in issue, disclosure must be made of the earliest and latest dates on which the company may redeem the shares, whether the shares must be redeemed in any event or only at the option of the company and the amount of any premium that may be payable on redemption.

There are a number of specific reserves which are required by law in certain circumstances. The most common of these are the capital redemption reserve, the share premium account and the revaluation reserve. On the redemption or purchase of its own shares out of profit, a company must transfer to the capital redemption reserve a sum equal to the nominal value of the shares redeemed or purchased, less the proceeds of any fresh issue of shares made for that purpose. This reserve may only be used to issue paid up bonus shares to the shareholders and, therefore, is not generally distributable. Where a company issues shares at a premium over their nominal value, the excess of the price paid over the nominal value must, in most circumstances, be transferred to a share premium account. The only exceptions to this relate to certain share exchanges attracting merger relief. The share premium account may not be distributed and can only be applied to issue fully paid bonus shares, to write off preliminary expenses (for example, incorporation costs), to write off the expenses of share or debenture issues or to provide the premium payable on the redemption of debentures. Any surplus or deficit arising on the revaluation of assets must be transferred to the revaluation reserve. The reserve should be reduced to the extent that it is no longer necessary, but transfers may only be made to the profit and loss account if they represent realised profits or the amounts in question were originally charged against income. Thus, the revaluation reserve is not generally distributable. The accumulated profit and loss account and any other realised reserves must be shown under 'other reserves' on the balance sheet. All these reserves are part of shareholders' funds, representing realised and unrealised profits or gains. Shareholders' funds are required to be separated into equity and non equity amounts by FRS4.

[3] Content of the Profit and Loss Account

The principal differences between the four prescribed formats for the profit and loss account lie in whether the various types of profit and loss items are listed separately or together and in the manner of describing and analysing expense items. FRS3 has augmented the existing statutory format.n17 Profit and loss accounts must be presented in a layered format, in order to highlight a number of important components of financial performance. The additional disclosures include the distinguishing of results of continuing operations (including the results of acquisitions) from the results of discontinued operations. The analysis between continuing operations, acquisitions (which are a component of continuing operations) and discontinued operations must be disclosed to the level of operating profit. The analysis of turnover and operating profit in this way is the minimum disclosure required on the face of the profit and loss account; analysis of the other figures may be performed in the note to the accounts.n18

[a] Detailed Disclosure. The disclosure requirements for the profit and loss account include detailed itemisation of various categories, including separate statements of certain amounts of income and expenditure either on the face of the profit and loss account or in the notes. Interest must be analysed into that arising from bank loans and overdrafts and that from other loans and disclosure must be made of auditors' audit and non-audit remuneration,n19 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.

The profit and loss account, or notes thereto, must contain various tax related disclosures. These include the amount of the charge to UK corporation tax for the year, together with any greater amount that might have been charged in the absence of double tax relief, the amount of the charge for UK income tax where applicable and the amount of the charge for non-UK tax of profits, income and capital gains (to the extent that it has been charged to revenue). All tax related disclosure should be analysed into amounts relating to profit or loss on ordinary activities and amounts relating to extraordinary profit or loss if applicable.n20 FRS16 and FRS19 on current and deferred tax respectively impose further disclosure requirements.

[b] Turnover Analysis. In addition to the analysis required in respect of continuing and discontinued activities, referred to above, there are various other disclosure requirements regarding analysis of the turnover figure. Turnover details must be differentiated by class of business and by geographical market where the company operates in more than one distinct geographical area. There is an exemption for any case where, in the opinion of the directors, disclosure would be seriously prejudicial to the interests of the company, but if this exemption is utilised it is necessary to state that the information has not been disclosed.n21

[c] Employees. The average number of employees during the financial year must be stated both in aggregate and analysed into separate categories of employment. Further disclosure is required of the aggregate amount of wages and salaries paid to employees, the social security costs and pension costs. There are specific disclosure requirements relating to directors.n22

[d] Extraordinary and Exceptional Items. The effect of amounts relating to a prior financial year and of exceptional items must be stated and particulars given of extraordinary items which should be shown separately in the profit and loss account in accordance with the prescribed format. Statute does not define the terms 'extraordinary' and 'exceptional'; however, FRS3 has provided specific guidance on the use of these categories.n23

[e] Items Excluded from Profit and Loss Account. Items which may be taken directly to reserves, bypassing the profit and loss account, are material adjustments to the results of prior years arising from changes in accounting policies or the correction of fundamental errors, unrealised surpluses on revaluations of assets, unrealised losses or gains on trade investments and currency translation differences on foreign currency net investments. However these items would have to be included in the statement of total recognised gains and losses required by FRS3.

[4] Statement of Recognised Gains and Losses

The statement of total recognised gains and losses is an additional primary financial statement required by FRS3. The purpose of this statement is to enable users to consider all recognised gains and losses of a company in assessing its overall performance and thus it includes the profit or loss for the period together with all the other movements on reserves reflecting recognised gains and losses attributable to shareholders. It refers solely to the financial year which is being reported on and does not reflect the realisation of gains recognised in previous periods. Transfers between reserves continue to be shown in the notes to the financial statements.

[5] Note of Historical Cost Profits and Losses

This note is required by FRS3. It is a memorandum item and its purpose is to present the profits or losses of reporting entities that have revalued assets on a more comparable basis with those entities that have not. Effectively, it is an abbreviated restatement of the profit and loss account, which adjusts the reported profit or loss, if necessary, in order to show the position as it would have been if no asset revaluation had been made. This note is required disclosure whenever there is a material difference between the result disclosed in the profit and loss account and the result on an unmodified historical cost basis. The note should be presented immediately following the profit and loss account, or the statement of total recognised gains and losses.n24

[6] Cash Flow Statement

The cash flow statement is a primary statement required by FRS1 and, although not required by statute, its inclusion in the financial statements is, with some exemptions, necessary in order to present a true and fair view. Individual flows of cash must be classified under prescribed headings, namely 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. Additionally, the cash flow statement should show a total giving the net cash inflow or outflow before use of liquid resources and financing. The operating profit reported in the profit and loss account and the net cash flows from operating activities should be reconciled in a note to the cash flow statement and

this reconciliation should disclose separately the movement in stocks, debtors and creditors relating to operating activities and other differences between cash flows and profits. Disclosure requirements also include a reconciliation of balance sheet items reported in the financing section of the cash flow statement with comparative figures for the previous year, showing separately the movement resulting from cash flows, differences arising from changes in foreign currency exchange rates and other movements.

There are exemptions from the requirement to produce the cash flow statement for small companies and 90% or more owned subsidiary undertakings which fulfil certain criteria.n25

[7] Group Financial Statements

[a] Requirement for Group Financial Statements. As indicated above,n26 a parent undertaking is required to produce consolidated financial statements which give a true and fair view of the state of affairs and results of its entire group, whether or not its subsidiary undertakings are incorporated in the UK. Both the form and content of consolidated financial statements are prescribed by law and are substantially the same as for single companies, except that the interest of minority shareholders in the subsidiary undertaking should be shown as a separate item in the financial statements. A separate profit and loss account for the parent company need not be included within the consolidated financial statements, although its profit or loss for the year must be disclosed.

A parent undertaking is not required to produce consolidated financial statements if it is itself a wholly owned subsidiary undertaking of another company (the 'holding company') which is incorporated under the law of a Member State of the European Economic Area (EEA)n27 or where the 'holding' company holds more than 50% of the shares in the parent undertaking and notice requesting the preparation of consolidated financial statements has not been served on the parent undertaking by shareholders holding in aggregate more than half its remaining shares, or 5% of its total shares, at least six months before the end of the financial year to which it relates.n28 This exemption does not apply to a parent undertaking which has any securities listed on a Stock Exchange in any Member State of the EEA. In all other circumstances, the exemption is conditional upon compliance with the following conditions:

-- the parent undertaking is included in consolidated financial statements for a larger group drawn up to the same date, or to an earlier date in the same financial year, by a 'holding company' established under the law of a Member State of the EEA;

-- those consolidated financial statements are drawn up and audited, and the 'holding company's' annual report is drawn up, according to the relevant law in accordance with the provisions of the Seventh Directive;

-- the parent undertaking discloses in its individual financial statements that it is exempt from the obligation to prepare and deliver consolidated financial statements;

-- the parent undertaking states in its individual financial statements the name of the 'holding company' which draws up the consolidated financial statements referred to above and details of its place of incorporation;

-- the parent undertaking delivers to the Registrar copies of those consolidated financial statements and of the 'holding company's' annual report, together with the auditors' reports on them, within the specified time limits; and

-- where appropriate, a translation into English is attached to any documents delivered to the Registrar.

There are various exemptions under which subsidiary undertakings may be excluded from consolidation. A subsidiary

undertaking may be excluded if it is not material to the group. However, if more than one subsidiary undertaking is to be excluded from consolidation on these grounds, then the aggregate of the number of subsidiary undertakings to be excluded must not be material to the group in total. Additionally, the CA 1985 provides that subsidiary undertakings should be excluded from consolidation where:

-- severe long term restrictions substantially hinder the exercise of the rights of the parent undertaking over the assets or management of that subsidiary undertaking; or

-- the information necessary for the preparation of group accounts cannot be obtained without disproportionate expense or undue delay; or

-- the interest of the parent undertaking is held exclusively with a view to subsequent resale and the subsidiary undertaking has not previously been included in consolidated group financial statements prepared by the parent; or

-- the activities of one or more subsidiary undertakings are so different from those of the other subsidiary undertakings to be included in the consolidation, that their inclusion would be incompatible with the obligation to give a true and fair view.n29

FRS2 modifies certain of those exemptions.

Where all the subsidiary undertakings of a parent undertaking fall under any of the above exclusions, no group financial statements are required. A further exemption from preparing group financial statements is available to groups which qualify as small or medium sized, ie if the group satisfies any two of the size criteria applicable to such groups relating to turnover, balance sheet total and average number of employees.n30

The financial year end of the subsidiary undertaking should coincide with that of the parent undertaking. Where they do not, interim financial statements for the subsidiary undertakings concerned should be prepared, made up to the parent undertaking's accounting reference date. If this is impracticable earlier financial statements of the subsidiary undertaking may be used, provided they are prepared for a financial year that ended not more than three months before the parent undertaking's accounting reference date.n31

Where a subsidiary undertaking has been excluded from consolidation on the grounds that its activities are so different from those of the other subsidiary undertakings to be included in the consolidation that its inclusion would be incompatible with the obligation to give a true and fair view, the interest of the group in that subsidiary undertaking, and the amount of profit or loss attributable to that interest, must be shown in the consolidated financial statements by the equity method of accounting.n32

Investments in 'associated undertakings' should be shown separately on the balance sheet.n33 An associated undertaking is one in which the investing company has a participating interest, which arises broadly where it holds shares on a long term basis for the purpose of securing a contribution to the investing company's own activitiesn34 and over which it exercises significant influence. Influence will be assumed if the holding of equity shares with unrestricted voting rights is more than 20% and, as with subsidiary undertakings, the test to be applied in respect of influence or control is dependent on the substance rather than the legal form of any investment arrangement. An investing company or group may, therefore, account for an associated undertaking in which it holds less than 20% of the equity provided it can be demonstrated that the investing company is able to exercise significant influence over the associated undertaking. Conversely, an investing group need not account for an associated undertaking in which it holds more than 20% provided it can be shown that the investor has no significant influence.n35 Investments in associated undertakings are required to be accounted for in the consolidated financial statements under the equity method whereby the group's share of an associated undertaking's profit before tax, taxation, extraordinary items and net profit retained are accounted for

from the date it becomes an associated undertaking of the group. Where it is exempt from preparing consolidated financial statements, (or would be exempt if it had any subsidiary undertakings), the investing company should give the required detail on the associated undertaking by preparing a separate profit and loss account or by adding information in supplementary form to its own profit and loss account. Where the associated undertaking is itself a parent undertaking, then the net assets and profits or losses to be taken into account are those of the parent and its subsidiary undertaking after making any consolidation adjustments.n36

[b] Content of Group Financial Statements. The only form of group financial statements permissible in the UK is consolidated financial statements. These comprise a consolidated balance sheet, profit and loss account, statement of total recognised gains and losses, cash flow statement and notes thereto dealing with the parent undertaking and all the subsidiary undertakings.n37

Consolidated financial statements combine the information contained in the separate individual financial statements of the parent undertaking and of the subsidiary undertakings but with such adjustments as the directors of the parent undertaking consider necessary. Consolidated financial statements must comply with the provisions of Schedule 4A of CA 1985 as if they were the financial statements of a single company. In addition the parent undertaking must produce its own individual balance sheet and related information. However, the parent undertaking's own profit and loss account need not be included within the consolidated financial statements, provided its profit for the year is disclosed.n38

The parent undertaking's individual balance sheet must show shares in group companies and amounts owed to and by group companies. The name of each subsidiary undertaking and in certain cases its country of incorporation or registration must be stated in the notes to the parent undertaking's accounts, and particulars of the classes and proportions (by nominal value) of each class of shares held by the parent undertaking must also be disclosed.

[8] Exemptions for Small, Medium-sized and Dormant Companies

[a] Small and Medium-sized Companies. Subject to certain exceptions detailed in paragraph [b] below, small and medium-sized companies are entitled to a number of exemptions relating to both statutory filing requirements and the content of their financial statements. Such companies may deliver abbreviated financial statements to the Registrar of Companies instead of their full statutory financial statements prepared in accordance with the Companies Act. To qualify as either small or medium-sized, a company has to satisfy certain size limits relating to turnover, balance sheet total and average number of employees.n39

A small company is permitted to exclude its profit and loss account and most of the notes referring to the make-up of balances in the balance sheet. Medium-sized companies may exclude details of turnover from the profit and loss account.n40

It should be noted that either type of company is required in the normal way to produce and lay before shareholders full statutory financial statements, although for small companies in particular they can follow Schedule 8 to the CA 1985 and the FRSSE whose requirements are significantly less onerous than those applying to larger companies.

A small company is not required to state that the financial statements comply with accounting standards; that is taken for granted unless a statement to the contrary is made. Small companies and groups are entitled to the various exemptions by following Schedule 8 to the CA 1985n41 as opposed to Schedule 4. Schedule 8 allows small companies and groups to prepare 'modified' financial statements, omitting much of the disclosure detail required for larger companies. These 'modified' financial statements are the full statutory financial statements for the purposes of the CA 1985. The exemptions are extended to small groups in cases where the parent undertaking has taken advantage of the exemptions in the preparation of its own individual financial statements. Additionally, parent undertakings of small and medium-sized groups are exempt from preparing consolidated financial statements if they meet the size criterian42 and are not ineligible, (*see* [b] below).

Where the directors of a company have followed Schedule 8, the company's balance sheet must contain statements by the directors to that effect. Where the financial statements are prepared using the FRSSE then it should be stated that this is the case. This statement may be included with the statement required by Schedule 8 or included with the note of accounting policies. If the company is not entitled to the exemptions claimed in the directors' statement then the auditors must state so in their report.n43

[b] Companies and Groups Ineligible for the Exemptions. A company or group will be ineligible for the exemptions detailed above if it is a public company, a banking or insurance company, or a person who has permission under Part IV of the Financial Services and Markets Act 2000 to carry on a regulated activity, or if it was at any time during that year a member of a group containing such a company.

[c] Dormant Companies. A dormant company is one which has had no 'significant accounting transaction'n44 during an accounting period. Dormant companies may be treated as eligible for the exemptions for small companies as regards the delivery of abbreviated financial statements to Registrar of Companies and the content of full statutory financial statements. A dormant company is ineligible for any of these exemptions if it is a banking or insurance company or a person who has permission under Part IV of the Financial Services and Markets Act 2000 to carry on a regulated activity. However, the exemptions relating to delivery and content of financial statements may apply to a dormant company which is a member of an ineligible group, unless it is in fact the parent undertaking of that group.

[9] Banking and Insurance Companies

Banking and insurance companies are not required to conform to the detailed requirements of Schedule 4 for the CA 1985 as detailed above. They must comply with the special disclosure requirements of Schedules 9 and 9A to the CA 1985.n45

[a] Banking Companies.n46 Following implementation of the EU Directive on the Annual Accounts and Consolidated Accounts of Banks and Other Financial Institutions, banking companies which are authorised institutions under the Banking Act 1987 and banking groups must prepare their individual and consolidated accounts in accordance with Schedule 9 of the CA 1985. The rules in Schedule 9 are broadly similar to those in Schedule 4, except that the formats for the balance sheet and the profit and loss accounts are different to reflect the special circumstances of banks. In addition there are particular rules on items such as subordinated assets, syndicated loans, and so on. In addition, there are five Statements of Recommended Practice (SORPs), issued jointly by the British Bankers' Association and the Irish Bankers' Federation, with which banks are expected to comply.

[b] Insurance Companies. Insurance companies, defined in the Insurance Companies Act 1982, and insurance groups are subject to the requirements of Schedule 9A which was amended in 1993n47 to reflect the requirements of the EU Directive on the Annual Accounts and Consolidated Accounts of Insurance Undertakings. Insurance companies' financial statements must give a 'true and fair' view. Schedule 9A contains detailed rules on determining general provisions and those for claims outstanding in insurance companies and sets out the balance sheet and profit and loss account formats.

Insurance companies are also separately regulated under the Insurance Companies Acts whereby they are required to comply with obligations in relation to solvency requirements, valuation of assets and liabilities and separation of life and general funds, as well as accounting standards. In addition, the Association of British Insurers issued a SORP'Accounting for Insurance Business' with which insurance companies are expected to comply.

[10] Additional Disclosure Considerations

[a] Directors' Report. Every set of statutory financial statements must be accompanied by a directors' report. This report must include a fair review of the development of the business of the company and its subsidiary undertakings

during the financial year, their position at the end of the year and statements of both the amount of any proposed dividend and the amounts to be carried to reserves. The report must also make various disclosures, regarding any significant changes/activities of the company and its subsidiary undertakings, any significant differences between the book value and the market value of interests in land, important post balance sheet events affecting the company or its subsidiary undertakings, likely future developments in business activities and any involvement in research and development.

Additionally, the report must contain details of any acquisition or disposal by the company of its own shares, political and charitable donations that exceed certain limitsn48 and, where the number of employees is greater than 250, it must state the company's policy as to the employment, training and promotion of disabled persons and various other employee involvement schemes. The report must contain the names of all persons who have been directors of the company at any time during the financial year and either the report, or the notes to the financial statements, must disclose details of directors' interest in shares or debentures of the company or its subsidiary undertakings. The directors' report should also contain a statement of directors' responsibilities (a requirement of the auditing standard SAS 600), although if this is omitted it can be included in the report of the auditors.

The directors' report of a public company, or a company which did not qualify as small or medium-sized and was at any time in the financial year a member of a group headed by a public company, is required to state the company's policy in respect of the payment of creditors. The details to be given will depend on whether it is the company's policy to follow a code of practice or standard (or equivalent) on payment practice. Where this is the case, then the report should state the name of the code and where information about it, or copies of it, can be obtained.

Where the company does not adhere to a code then the directors will need to indicate whether it is the company's policy to settle terms of payment with its suppliers when agreeing the terms of each business transaction, whether it ensures that each supplier is aware of these terms and whether the company intends to abide by the agreed terms of payment. If a company does not follow either of the two policy options above then the company would be required to disclose its policy in respect of paying its suppliers. Where a company's policy is different for different suppliers then the report would need to state on what basis the company distinguishes between suppliers.n49 Furthermore, the number of creditor days, being the amount owed to trade creditors at the end of the year compared with the amount invoiced by suppliers in the year, must be given in the directors' report.

In their report, the directors of a small company may take advantage of a number of exemptions,n50 which allow many of the required disclosures to be dispensed with. If they have taken advantage of any of the exemptions, the directors are required to state in their directors' report and on the balance sheet, that the accounts have been prepared in accordance with the special provisions relating to small companies within Part VII of the CA 1985.

[b] Other Disclosures in the Accounts. Various provisions of the CA 1985 require disclosure in the financial statements of certain transactions with directors, for example: loans, quasi loans and credit transactions and guarantees or similar arrangements where these are permitted by law. Although it is generally prohibited for companies to make loans to the directors, there are a number of exceptions, particularly in relation to banking companies. However, even in the case of banking companies, disclosure of the amount of permitted loans is required. If disclosure is not made the auditors are required to disclose the amounts concerned in their audit report.

[c] Listed Companies. In addition to the requirements of the CA 1985, a company which is listed, i.e. a company with any class of its securities admitted to the Official List of the UK Listing Authority (UKLA), undertakes to comply with the requirements of'The Listing Rules' of the Financial Services Authority (FSA) with regard to the content of its report and accounts.n51 It must include specific information, in addition to that required by the CA 1985 and accounting standards, on a variety of topics, including:

-a commentary on any published forecasts or estimates, where the results for the period under review differ by ten per

cent or more;

-shareholders' dividends and directors' emoluments waived;

-changes in directors' share interests after the year end;

-substantial shareholdings;

-a statement by the directors that the business is a going concern with supporting assumptions or qualifications as necessary;

-a report to shareholders by the board on directors' remuneration which should include, or cross refer to, extensive details of individual directors' remuneration; and

-statements regarding compliance with the'Code of Best Practice' on corporate governance and the application of the Principles of Good Governance which are contained in the'Combined Code.'

A listed company need not send copies of the company's detailed financial statements, directors' report and auditors' report to members of the company but may instead send a summary financial statement. Copies of the detailed financial statements must however be sent to any member of the company who wishes to receive them. The summary financial statements must be derived from the company's detailed financial statements and directors' report and must contain information specified by the Secretary of State.n52

Although under the CA 1985 public companies are to deliver their financial statements to the Registrar of Companies within seven months after the end of the accounting reference period,n53 the Listing Rules require listed companies to produce them within six months of the end of the financial periods to which they relaten54 and also to prepare a half-yearly report on the group's activities and profit and loss during the first six months of each financial year (which need not be audited)n55 within 90 days of the end of that period.

[d] Private Companies. A private company may elect, by elective resolution in accordance with CA 1985 s 379A, to dispense with the laying of financial statements before the shareholders in general meeting.n56 Where such an election is in force, shareholders retain the right to require laying of accounts, subject to the terms of CA 1985 s 253.

[e] Persons Conducting a Regulated Activity Requiring Permission Under Part IV of the Financial Services and Markets Act 2000.n57 The Financial Services and Markets Act provides that a person carrying on, or purporting to carry on, investment business in the UK musthave permission. The purpose of the Act is to afford investors some measure of protection. Detailed rules have been formulated dealing with the production and presentation of accounting information in order to enable the Financial Services Authority ('FSA') to monitor the performance of the regulated businesses, for the better protection of the investors.

FOOTNOTES:
(n1)Footnote 1. *See* Section 21.03[9].

(n2)Footnote 2. European Parliament Regulation 2002/3626.

(n3)Footnote 3. *See* Section 21.03[8] for small and medium-sized company exemptions.

(n4)Footnote 4. These formats are set out in Appendix 21A.

(n5)Footnote 5. CA 1985 s.262.

(n6)Footnote 6. CA 1985 Sch4, paragraph 20.

(n7)Footnote 7. SSAP19.

(n8)Footnote 8. CA 1985 Sch7, para. 1.

(n9)Footnote 9. CA 1985 Sch5, para. 7.

(n10)Footnote 10. The relevant financial year of an undertaking is either the financial year that ends on the same date as that of the reporting company if they have the same reporting date, or the most recent financial year ending before the financial year of the reporting company. (CA 1985 Sch5, paragraph 17(4)).

(n11)Footnote 11. CA 1985 Sch4, para. 31.

(n12)Footnote 12. FRS15, paragraph 61.

(n13)Footnote 13. CA 1985 Sch4, para. 48.

(n14)Footnote 14. CA 1985 Sch4, para. 41.

(n15)Footnote 15. CA 1985 Sch4, para. 46.

(n16)Footnote 16. CA 1985 Sch4, para. 50.

(n17)Footnote 17. *See* Appendix 21B for example primary statements.

(n18)Footnote 18. *See* Appendix 21B.

(n19)Footnote 19. CA 1985 s.390A(3) and s.390B.

(n20)Footnote 20. CA 1985 Sch4, para. 54.

(n21)Footnote 21. CA 1985 Sch4, para. 55.

(n22)Footnote 22. CA 1985 s.232.

(n23)Footnote 23. *See* Section 21.05[1][a][ii].

(n24)Footnote 24. *See* Appendix 21B.

(n25)Footnote 25. FRS1.

(n26)Footnote 26. *See* Section 21.02[2][b][vi].

(n27)Footnote 27. CA 1985 s.228. The EEA came into effect on 1 January 1994 and extended the European Community single market to participating member states. The term therefore covers Norway, Iceland and Liechtenstein as well as the European Union (EU) countries (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Republic of Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the UK).

(n28)Footnote 28. CA 1985 s.228.

(n29)Footnote 29. CA 1985 s.229.

(n30)Footnote 30. *See* Appendix 21C.

(n31)Footnote 31. CA 1985 Sch4A, paragraph 2.

(n32)Footnote 32. CA 1985 Sch4A, paragraph 18.

(n33)Footnote 33. CA 1985 Sch4A, paragraph 21 and see Section 21.05[1][a][vi] for the requirements of FRS9 on associates and joint ventures.

(n34)Footnote 34. CA 1985 s.260.

(n35)Footnote 35. CA 1985 Sch4A, para. 20.

(n36)Footnote 36. CA 1985 Sch4, para. 22.

(n37)Footnote 37. CA 1985 s 227; *see* Section 21.05[1][a][v] for the requirements of FRS2 concerning the form of group accounts.

(n38)Footnote 38. CA 1985 s.230.

(n39)Footnote 39. For the size limits of a small or medium-sized company, see Appendix 21C.

(n40)Footnote 40. CA 1985 ss.246 and 249; Sch8.

(n41)Footnote 41. CA 1985 s 246.

(n42)Footnote 42. *See* Appendix 21C.

(n43)Footnote 43. CA 1985 s.237.

(n44)Footnote 44. CA 1985 s.249AA.

(n45)Footnote 45. CA 1985 s.255A.

(n46)Footnote 46. *See* Banking Act 1987, Ch 45 *infra.*

(n47)Footnote 47. SI 1993/3246, The Companies Act 1985 (Insurance Companies Accounts) Regulations 1993.

(n48)Footnote 48. CA 1985 Sch.7, paras.3-5.

(n49)Footnote 49. CA 1985 Sch7, para. 12.

(n50)Footnote 50. CA 1985 s. 246(4).

(n51)Footnote 51. Paragraph 12.43 of the Listing Rules.

(n52)Footnote 52. CA 1985 s. 251.

(n53)Footnote 53. CA 1985 s. 244(1).

(n54)Footnote 54. Paragraph 12.42(e) of the Listing Rules.

(n55)Footnote 55. Para. 12.48 of the Listing Rules.

(n56)Footnote 56. CA 1985 s.252.

(n57)Footnote 57. *See* further Ch 46A *infra.*