



CHARTERED CERTIFIED ACCOUNTANTS

## **DISCLOSURE PROBLEMS**

Over the last few years the accountancy profession has become increasingly more and more bureaucratic, with much more emphasis being placed on disclosures and the overall way in which financial statements are prepared.

Limited companies in the UK have to prepare financial statements in accordance with Generally Accepted Accounting Practice (commonly referred to as 'GAAP'). The GAAP in the UK specifies the framework in which financial statements are to be prepared and details the relevant disclosure requirements which must be disclosed within the financial statements (either within the primary financial statements themselves, or by way of note).

The various professional accountancy bodies have procedures in place, which monitor the way in which practitioners prepare financial statements. These procedures are referred to as 'monitoring visits' or 'assurance visits'. A few years ago, the body which monitored professional firms was known as the Joint Monitoring Unit (JMU). The purpose of these visits were to predominantly look at firm's audit clients to ensure the practice was complying with the now defunct SASs and to ensure the files met the minimum standards required by the Auditing Practices Board. Audit is becoming less predominant with smaller and medium-sized practices due to the substantial increases in the thresholds over the years. A further increase in the thresholds is due to take place in April 2008.

As a result, the professional bodies now look at, not only, a firm's audit client portfolio, but also may review non-audit clients – in particular Limited companies. This article is confined to small limited company financial statements and does not refer to audit.

### **The Primary Financial Statements**

In UK GAAP, a corporate entity is required to produce, on an annual basis, a set of financial statements, which comprise:

- A balance sheet as at the last day of the reporting period;
- A profit and loss account as at the last day of the financial year;
- Where appropriate, a cash flow statement; and
- Notes to the financial statements.

For those companies reporting under the Financial Reporting Standards for Smaller Entities (FRSSE), then the FRSSE encourages, but does not make it mandatory, for a corporate entity to produce a cash flow statement. FRS 1 *Cash Flow Statements* also exempts small companies from producing a cash flow statement.

## **Common Disclosure Errors**

The problem faced with professional firms of accountants is that a lot of firms place heavy reliance on their accounts production packages. Primarily, accounting software packages often only produce a 'skeleton' once, say, a trial balance has been entered into it. In recognition that every company is different and have different users of their financial statements, which often require varying degrees of financial information, accounting software packages will have facilities in place to tailor various disclosure requirements.

For example, a company operating in the manufacturing industry that has a secured bank loan will have to disclose the bank loan as a 'secured debt'. Whereas, a similar company who does not have any form of finance or loans will not have to make such a disclosure.

When reviewing files for corporate entities, it is extremely easy to place reliance on the accounts production software and forget that under the reporting standards, some disclosures do not have to be made or those that have been made in the financial statements are often incorrect, missed out completely or contain 'over-disclosure'.

Some of the more common disclosure errors are:

### **Directors' Report**

#### **Directors' interests**

From April 2007, director's interests in the shares of a company no longer have to be disclosed in the directors' report. Only the names of the directors who were on the board at any point during the year have to be disclosed. If any director was appointed or resigned during the year, then the directors' report should contain the date of appointment or resignation of the respective directors'.

#### **First year/period companies**

For those companies who have commenced trading and the preparer is preparing their first year accounts, the date of incorporation is required to be disclosed.

#### **Political or charitable donations**

If a company makes charitable donations which exceed £200, then the directors' report must contain details of the names of the charities, the relevant amounts and the purpose of the donations. Similarly, political donations in the EU, which exceed £200, should also be disclosed in the directors' report. Please note that £200 relates to individual donations in total, not just individual donations.

#### **Close companies**

Often firms disclose that a company is considered 'close' for taxation purposes. This disclosure is not required.

### **Name of person signing the directors' report**

Firms often forget that the name of the person signing the director's report and the capacity in which they are signing is required.

## **Disclosure errors in the Notes to the Financial Statements**

### **Basis of preparation**

Often the basis of the preparation of the financial statements is not disclosed. This is particularly the case if accounts have not been prepared on a reliable accounts production software package. The basis of preparation of the financial statements should disclose the way the accounts have been produced (often under the historical cost convention) and under which framework. A typical note will say:

*"The financial statements have been produced under the historical cost convention and in accordance with the Financial Reporting Standards for Smaller Entities (effective January 2007)".* Note that reference to the correct version of FRSSE should be made.

### **Accounting policies**

The notes to the financial statements should disclose a company's material accounting policies. It is often the case that accounting policies are disclosed but are not applicable. For example, if a company has foreign exchange transactions, then there should be a foreign exchange policy, which states the translation policies relating to assets, liabilities and profit and loss account transactions.

The common errors found in respect of accounting policies are:

### **Turnover note (accounting policies)**

The turnover note often refers to net invoiced sales of goods, excluding VAT and net of trade discounts. However, since the inception of UITF 40 or Application Note G to FRS 5, it is often the case that where a company has long-term service contracts, or could have long-term service contracts, that disclosure of revenue recognition in respect of long-term service contracts is omitted i.e., that revenue is recognised when a right to consideration exists. Judgement in these areas has to be made. For example, it is highly unlikely that an off-licence will have long-term service contracts, so in this respect the additional note relating to UITF 40 is not appropriate. However, a company operating in the construction industry will almost certainly have long-term service contract(s) and therefore UITF 40 is applicable.

### **Fixed assets**

Often companies just disclose the depreciation rates applicable to the company. It can also be the case that depreciation rates disclosed in the financial statements are often not the depreciation rates actually used when a file review is done.

The fixed asset disclosure in the accounting policies note should not just contain the depreciation rates. After all, the note is in relation to 'fixed assets' and not just depreciation.

The note should refer to the way in which a fixed asset is measured in the financial statements. For example the note could say:

*“Fixed assets are stated at their cost prices, less accumulated depreciation and less amounts recognised in respect of impairment”.*

### **Stock**

It is common to rely on accounts production software to generate the standard SSAP 9 note which states that stock is valued at the lower of cost or net realisable value. Preparer’s either forget, or are not aware, that the basis of stock valuation should be disclosed e.g. whether stock is value on a first-in first-out (FIFO), last-in first-out (LIFO) or weighted average basis.

### **Financial instruments**

Financial instruments are often considered by smaller firms as being applicable to listed companies. This is not the case. A financial instrument can be a bank loan, a bank overdraft, debtors, creditors and such like. Where a company has material loans and material financial instruments, then it should disclose the accounting policy it has adopted in respect of these financial instruments. Even smaller limited companies should consider their financial statements and how material they are. Remember, only the material accounting policies need to be disclosed.

### **Pensions**

In the UK a company may have a defined benefit pension scheme or a defined contribution pension scheme – or both.

This article is not going to go into the various disclosure requirements a defined benefit scheme has to disclose because the disclosures are quite complex and long-winded. However, for a defined contribution scheme, disclosure should be made that the scheme is a defined contribution scheme and that payments into the scheme are written off to profit and loss. Some practitioners who prepare accounts using non-accounts production software packages often forget to include this note.

### **Directors’ emoluments**

This is a particular easy note to get wrong. The director’s emoluments should include: directors salaries, compensation for loss of office, benefits in kind and any pension contributions.

Disclosure as to how many directors’ amounts accruing under pension contributions should also be made. This is a particularly common disclosure omission. If the company makes payments into (let’s say) a defined contribution pension scheme for a director(s) then the number of directors for whom the company makes payments into should be made.

It is also common for employer's national insurance contributions to be included in the amounts disclosed as directors' remuneration. Employer's national insurance contributions should not be included as they are a cost to the company alone.

### **Deferred tax**

Again, this is a note which practitioners rely on their accounts production software package to get right.

Deferred tax should only be disclosed as an accounting policy if the company has deferred tax. The method of measuring deferred tax should also be disclosed i.e. whether it is discounted or undiscounted (often in the UK, deferred tax is accounted for as undiscounted). The policy for deferred tax assets (e.g. if a company has tax losses which it is carrying forward) should also be disclosed.

Those are the common errors and omissions in terms of the accounting policies. The following are the common errors and omission in the notes to the financial statements:

### **Turnover**

If a company supplies goods/services overseas, it should disclose the percentage of goods in European and non-European countries.

### **Debtors (UITF 40)**

Where UITF 40 in respect of long-term service contracts is appropriate it is often the case that companies will include any amounts recoverable on contracts within Trade Debtors or Work-in-Progress. This is not the correct treatment. Any amounts which are recoverable on long-term service contracts should be shown within debtors but under the heading 'Amounts Recoverable on Contracts'.

### **Secured debts**

If a company has secured overdrafts, bank loans, hire purchase contracts and such like which are secured, these amounts should be disclosed under the heading 'Secured Debts'.

### **Corporation tax**

The rates of corporation tax charged are not required to be disclosed.

### **Dividends**

Dividends paid to shareholders are no longer shown on the face of the profit and loss account. Dividends paid are shown in the notes to the financial statements as a reconciling item under the 'Reserves' note which reconciles the opening and closing balances shown in the company's profit and loss reserves.

### **Deferred tax**

The deferred tax note should state the balance of deferred tax brought forward, the movement in the year and the nature of the movement e.g. accelerated capital allowances and the deferred tax balance at the end of the year.

### **Ultimate controlling party**

If a company has a shareholder who holds 51% or more of the ordinary share capital, this person is the controlling party and the name of the person should be disclosed as the controlling party. Their holding is not required to be disclosed.

### **Assets stated at revalued amounts**

If a company adopts a method of revaluing its fixed assets then it should disclose the cost and aggregate depreciation that it would disclose had it not been subject to valuation. The note should also disclose who undertook the valuation and the date the valuation occurred.

Similarly a company should disclose within the corporation tax note, the amount of corporation tax that it would have to pay if the revalued assets were sold at their carrying values in the balance sheet.

If a company has adopted the revaluation model for its fixed assets and it has not revalued its fixed assets in the intervening years required by the standards, then a note to the financial statements stating that the company has breached the accounting standards should be made.

### **Related parties**

If a director, shareholder or the company holds interests in another company, which they trade with, they must disclose the value of trade between the two companies, the value of monies outstanding to and from the company at the balance sheet date and the terms of the trading i.e. on normal commercial terms. The related party note is often the note which contains errors and omissions. It is advisable to look at FRS 8 '*Related parties*' or FRSSE 2007, chapter 15 page 75 to understand the disclosures required in respect of related party transactions.

### **Transactions with directors**

Any directors' loans or quasi-loans should also be disclosed and the maximum amount outstanding during the reporting period should also be disclosed. If creditors falling due within one year contain the director's loan account(s), then a note under 'Transactions with Directors' should be made in the notes stating that the loan accounts were not overdrawn during the year.

### **General errors**

Accounts prepared by chartered accountancy firms which include the accountants report issued by the Association of Chartered Certified Accountants. Each professional body usually has their own version of the accountants report.

Accounts prepared under FRSSE but which refer to full FRS. If you are reporting under FRSSE you should only refer to FRS if the transaction or event concerned is not covered by FRSSE. These instances are quite rare.

Accounts referring to the wrong version of FRSSE. The latest version of FRSSE is effective from January 2007 and can be adopted earlier, whereas FRSSE 2005 could not be adopted early.

The word 'Abbreviated' not being contained within the abbreviated financial statements.

Companies that are eligible to publish abbreviated financial statements publishing absolutely everything including a detailed profit and loss account. The detailed profit and loss account is not a statutory document.

Where LLPs publish their accounts, the report of the members is not a statutory document and therefore does not need to be submitted to Companies House. A limited company has to have a director's report, but a LLP does not have to have a members report.

Extraordinary items in the notes to the financial statements being present. Extraordinary items are no longer permissible – exceptional items are.

Authorised share capital not being disclosed in the financial statements.

Cross references from the amounts in the primary financial statements to the notes being incorrect. For example, note 3 in the notes to the financial statements may be the corporation tax note, but on the face of the income statement, corporation tax may be cross referenced to note 4.

The balance sheet and cash flow statement (where prepared) not actually balancing. This is more common than people actually think!

### **Conclusion**

This article aims to highlight the common disclosure failings made when preparing a set of financial statements for a smaller company in the UK. The article cannot pinpoint every failing made but the above are the more common issues faced by smaller firms of accountants who prepare small limited company accounts. Over reliance on accounts production software packages should not be encouraged as these packages often do not generate the required disclosures a client has to make in their financial statements.

To overcome failings there are various 'Accounts Disclosure Checklists' which can be bought to help preparers of accounts make the right disclosures and avoid errors and ensure that the accounts they are preparing contain all the right disclosures where appropriate and avoid 'over disclosure'. It is advisable to subscribe to company's that provide the checklists and model accounts, which illustrate the relevant disclosures required. Often annual subscriptions to these types of outlets enable updates to be given if there are any changes within the Companies Acts of Financial Reporting Standards.

**Steve Collings FMAAT ACCA is Audit Manager at Leavitt Walmsley Associates Limited.**