Third Edition

FINANCIAL INFORMATION ANALYSIS

THE ROLE OF ACCOUNTING INFORMATION IN MODERN SOCIETY

Philip O'Regan

FINANCIAL INFORMATION ANALYSIS

The accounting landscape shifted following the era of global financial crisis and accounting information continues to play a vital role. Philip O'Regan's authoritative textbook provides readers with the tools and techniques to fruitfully analyse accounting and financial data.

Updated to reflect changes in corporate governance, regulatory frameworks and IFRS, the text continues to shed light on the growing emphasis placed on the role of accounting information in formulating financial strategy.

Features that add value to this third edition of *Financial Information Analysis* include case studies in every chapter with numerous supporting articles from the major financial presses, questions for review and a comprehensive companion website. This essential textbook is core reading for advanced undergraduate and postgraduate students of finance and accounting.

Philip O'Regan is Senior Lecturer in Accounting and Finance and Dean of the Kemmy Business School at the University of Limerick, Ireland.

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FINANCIAL INFORMATION ANALYSIS

The role of accounting information in modern society

Third edition

PHILIP O'REGAN

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PREFACE

At first glance, it seems obvious that this bird is destined for the dinner table. Two apparently cruel and merciless humans are about to ensure their quest ends successfully. If, however, you are given more information, for instance that this photograph was taken during one of the coldest winters in Europe in recent years, then the event takes on an entirely different perspective. Far from intending to devour the bird, those in the boat are actually trying to free it from the surrounding ice!

Financial information is a little like a photograph – it is essentially information presented from a particular, and often self-interested, perspective. Only when additional contextual information is obtained can the true significance of the information be properly appreciated.

The manner in which this text is structured reflects this insight. At all points readers are reminded of the need to gather additional information in order to properly appreciate the significance of the financial information being interpreted. Just as the information about the cold winter is important in

allowing a proper interpretation of what is happening in the photograph above, additional insights about companies, markets and information dynamics in general will often be critical.

ACCOUNTING INFORMATION AND ACCOUNTANTS

Accounting information plays a crucial role in modern commerce and society. As a consequence, so do accountants. However, in the wake of the recent international financial crisis as well as a number of large frauds and financial scandals, accountants find their role being challenged, and the usefulness of their primary outputs questioned.

The events surrounding the collapse of RBS, Northern Rock, Enron, WorldCom, Parmalat and others have been catalysts for significant changes in the way in which accounting information is viewed by users (such as shareholders and analysts) and regulated by governments and other interested parties. Ironically, the extent and rapidity of these changes are testament to the enduring importance of accounting information in modern society: the capitalist system depends on a reliable and dependable flow of accounting information and, while heavily criticized, few viable alternatives to accounting information have been proposed.

IN PRACTICE

Seeing the wood for the trees, by Sally Percy

Financial reports have earned a bad reputation over the years. Maligned for being too long and cluttered, hard to navigate and stuffed with meaningless marketing speak, these important documents of record have suffered an endless stream of criticism. In 2007 HSBC's 454-page annual report, weighing in at 1.36kg, was even slated as a health and safety risk after Royal Mail banned its postmen from carrying more than 10 at a time for fear of back injuries.

Then the financial crisis hit. Financial reports were held partly responsible for the meltdown in the banking sector, both for disclosing too much and for not disclosing enough about the risks institutions were taking. Four years on, financial reporting remains under the scrutiny of regulators, standard setters, accountancy bodies and the government.

Financial statements may be designed with the interests of investors in mind but they're used by a range of stakeholders. Nevertheless, their shortcomings mean they could be failing to meet the needs of any group of stakeholders fully – investors included. "External reporting is focused largely on investors as opposed to other stakeholder groups and is

> mainly historic," says Simon Bittlestone, commercial director at business analyst Metapraxis. "It has little forward-looking financial information on likely future achievement, which is vital for investor decisions. It also often lacks insight and is generally a of numbers with little trend information or context."
>
> … Given the political importance that financial reporting has assumed since the financial crisis, it's no surprise there are efforts to improve it.
>
> Source: *Economia*, 2 November 2014

This importance – acknowledged in this extract, in spite of its flaws – is especially obvious in those environments where accounting is recognized as a primary means of communication. In a world in which more and more people can expect to have to deal with complex financial information, and a growing proportion of the population acquires shares, this importance can only increase.

This text reflects these developments by seeking to address the nature and role of accounting information in modern society. It focuses on one of the principal accounting documents – the annual report – which in the Anglo-American world is normally produced annually by every company. A primary aim of this text is to equip readers with the skills needed to appreciate the information content of this and other accounting documents.

The most significant feature of this text is that it places the discussion and analysis of the information contained in the annual report in as broad a set of contexts as possible. At its most basic this means recognizing that the annual report itself only partly comprises what is traditionally understood to be accounting information, that is financial data in a recognizable financial statement. In fact, reflecting the limited capacity of accounting numbers to communicate the essence of any corporate entity, and responding to the information requirements of an increasingly large range of users, the annual report has become a substantial document containing a wealth of non-accounting information. For example, directors' reports, chairman's statements, commentaries on the environmental impact of corporate activity, as well as information presented in the form of graphs and tables now supplement the basic accounting statements.

IN PRACTICE

While the annual report is often criticized, there are some very good examples of best practice. The following extract identifies the annual reports of BP and Prudential as examples that have sought to respond to political and investor pressure for change. You can find copies of the reports referred to at www.bp.com/en/global/corporate/investors/results-and-reporting.html and www.prudential.co.uk/investors/financial-highlights, respectively.

How to Report Clearly and Concisely, by Julia Irvine

The annual reports of BP and Prudential are being held out by the Financial Reporting Council (FRC) as examples of how companies can achieve clear and concise reporting …

Prudential's annual report, the FRC says, has changed significantly over the last two years, even though the group has adopted an evolutionary, rather than revolutionary, approach to improving the readability of the content. Nevertheless, the group's business has been described more concisely and the format streamlined to reduce the number of pages in the report by more than 100. In 2011, the annual report stood at 479 pages, a total which was reduced to 399 in 2012 and to 384 in 2013.

… BP faced additional problems in trying to make its annual report clearer and more concise because of its dual listing in the UK and the US. This means that the annual report has to double up as its US filing document. However, involving both UK and US legal teams early in the project proved useful "as they provided great objective challenge." As a result, BP's annual report is now 5% shorter than it was two years ago, down from 303 pages to 288.

Source: *Economia*, 12 August 2014

At another level, this broader contextualization means that issues such as the role of governance cultures, the demand for and supply of accounting information, and the regulatory, legislative and conceptual frameworks within which accounting information emerges are also investigated.

In seeking to broaden our understanding of the information content of the annual report, the text makes liberal use of extracts, quotations and articles from a variety of sources. This is done not only to supplement the narrative with original and incisive comment, but also to introduce readers to insights that often contradict my own viewpoint. The result is that the reader is challenged to confront issues and assimilate varying perspectives, rather than simply adopt one writer's prejudices.

WHAT IS "FINANCIAL INFORMATION ANALYSIS"?

Financial information is presented in various forms. Financial statements, such as the balance sheet, income statement and cash-flow statement that are found in an annual report, are probably the most common means by which financial information is made available.

These are complex documents, constructed according to detailed rules and regulations that reflect the accumulated wisdom of generations of accounting practice. In other words, they can often be extremely difficult to understand. It becomes necessary, therefore, to learn how to "read" them.

As employed in this text, the term "financial information analysis" describes the processes and techniques used to identify and extract the critical information contained within financial statements and any supporting documentation. Thus, insights and skills developed by users of accounting information over many decades form a critical part of this text and are covered in considerable detail.

Significantly, the application of these techniques and processes is not presented as an end in itself. On the contrary, financial information analysis is presented as a more holistic exercise that contributes to an informed and balanced decision-making process. This process includes the application of various analytical techniques and skills. Critically, however, these are considered with reference to the broader strategic, commercial and social contexts that impact every commercial entity. Thus, the needs of a variety of users are considered, while the notion that any one interest group should dictate the financial reporting agenda is challenged.

FUNDAMENTAL ANALYSIS

The perspective, techniques and skills adopted in this text can be broadly grouped under the heading "fundamental analysis". This is an approach that seeks to analyse and interpret a company by investigating its fundamental financial, strategic and human elements.

This distinguishes it from "technical analysis", an approach that focuses more on stock-market measures and seeks to find indications of future share performance in historical patterns.

The text is divided into five sections and an appendix as follows.

I CONTEXT

The text begins with an identification and discussion of the various contexts within which corporate financial communication should be considered. The intention is to

challenge readers to consider the various forces and influences that have conjoined to produce financial information in the forms in which it currently emerges.

Separate chapters are devoted to the following topics:

- Regulatory context
- Conceptual context
- Theoretical context
- Governance context

In discussing these, particular attention is paid to international issues and current developments.

II CONTENT

The annual report is a substantial document containing a huge volume of information in various formats, only some of which are recognizably financial in nature. The second section of the text is devoted to a detailed analysis of the reporting and disclosure requirements underpinning what should be included in an annual report.

These requirements are considered under two headings, reflecting the most obvious subdivision in the nature of the information contained in an annual report:

- Annual report: narrative
- Annual report: financial

III ANALYSIS

Since one of the primary functions of the text is to equip readers with the ability to identify and extract the key information from an annual report, a separate section is devoted to explaining one of the more popular and useful means by which this is traditionally achieved – fundamental analysis. Under headings that reflect the principal areas of concern for most large corporate entities, readers are introduced to the main techniques of fundamental analysis and encouraged to use these in analysing financial information. They are also made aware of the limitations of this approach and, most importantly, of the fact that techniques such as these are merely a means to an end.

Reflecting the principal areas of corporate activity, this section includes chapters dealing with the following:

- Fundamental analysis

- Activity and liquidity
- Financing
- Profitability and return on investment

IV ISSUES

This section deals with some of the more complex elements of financial accounting practice as these will need to be understood in order to analyse the financial statements of larger entities. These issues are considered in an international context and accounting practice in the UK is compared with that in the US and several continental European countries.

In addition, readers are alerted to some of the more common creative accounting techniques, as well as developments such as those occurring in the area of corporate social responsibility.

Chapters addressing the following issues are included in this section:

- Business combinations
- Pensions, share options, leases, taxation, and foreign currency
- Creative accounting
- Corporate social responsibility
- International accounting

V STRATEGY AND VALUATION

This is a completely new section comprising two chapters on strategy and business valuation. These additions are in response to feedback on previous editions of this text and reflect the fact that, increasingly, accounting information needs to be approached from a strategic, as distinct from a technical, perspective. Valuation is also presented in this context, exploring various valuation options in the context of strategic acquisition opportunities. This fits perfectly with the overall approach of the text which seeks to place accounting information in its decision-making context.

The two chapters in this final section are:

- Strategy
- Business valuation

APPENDIX

Throughout the text, reference is made to the annual reports of a number of companies. However, particular attention is given to the Debenhams 2014

Annual Report. This is an exemplary annual report, and in Chapters 8, 9 and 10, in particular, it is used as the basis on which ratios and other performance metrics are illustrated.

These are brought together in the Appendix, where an example of a company report based on an analysis of Debenhams is provided. This is updated on an annual basis and these updates are available on the website.

This company report brings together the various skills and contextual understandings gained so far. The purpose is to allow readers to see how these techniques can be applied, and to highlight the fact that the process of interpreting such information involves more than merely the application of these skills.

For reference purposes, you can access the Debenhams Annual Report 2014 at: http://media.corporate-ir.net/media_files/IROL/19/196805/agm2014/annual_report_and_accounts.pdf

UNIQUE FEATURES

This text employs several unique features in communicating the relevance and immediacy of the topic:

- The role of accounting information as an aid to the decision-making process is emphasized.
- The text is based on International Financial Reporting Standards (IFRS), the most widely used international accounting standards.
- Readers are not immediately confronted with masses of technical information. Thus, Section I introduces readers to fundamental theoretical and conceptual issues that need to be considered when approaching accounting information.
- Extracts from newspapers, journals and websites are employed liberally in order to elaborate on points made within the text and, on occasion, to illustrate alternative viewpoints.
- Each chapter starts with learning objectives that set out clearly what is covered.
- "In practice" inserts are used to demonstrate how various regulatory, legislative and other provisions translate into practice.
- "In depth" sections in several chapters direct readers to the text website for more information on topical and/or complex issues relevant to the chapter in question.
- "Review questions" at the end of each chapter enable readers to review the principal elements of the chapter.
- End-of-chapter "Case studies", often incorporating detailed extracts from other sources, are intended to stimulate discussion as well as allow readers to investigate particular events and companies in more detail.

- Readers are referred to various websites for supplementary reading and information.
- While UK accounting is placed firmly in the Anglo-American context to which it belongs, international comparisons constantly alert readers to the fact that alternative practices and perspectives exist.
- Interpretation is identified as an intuitive process that is assisted by techniques, contextual grounding and experience where the whole is often greater than the sum of the individual parts.
- The interests of stakeholders other than shareholders are considered.

COMPANION WEBSITE

Considerable use is made of the companion website for the text, which can be found at www.routledge.com/cw/oregan. There readers will find additional materials such as:

- "In depth" topics discussed in more detail and supplemented by up-to-date material;
- supplementary materials such as additional computational questions, answers to various questions included in the text and illustrative examples are also available;
- updated company reports;
- regular updates on regulatory and other initiatives that are needed to remain up-to-date.

In addition, lecturers using the book as a course text will find:

- answers to each chapter's "Review questions";
- answers to supplementary and other computational questions;
- PowerPoint slides for each chapter.

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I would like to thank Sheila Killian, Ken O'Sullivan, John Heneghan, John McCarthy and Orla Lenihan, who contributed in various ways to this edition.

INTRODUCTION

THE PLAGUE, BY DAVID SMITH AND JOHN WAPLES

Rod Aldridge, chairman of Capita, was locked in a meeting with his City advisers last Wednesday to prepare the half-year statement due later this month. Aldridge was unusually upbeat. Two days earlier he had dined with a number of investors and there had been unbridled support for the FTSE 100 outsourcing group. But just as the meeting began, shares in Capita dropped like a stone. They collapsed 13% and Aldridge was stunned. The market had been spooked by fears that the company was losing a big government contract as well as by concerns about its accounting. Capita managed to calm the market but the damage had been done and the shares closed 4% down on the day. “It was unreal,” says Aldridge. “There is a complete over-reaction to everything at the moment. Our accounts are as conservative as you can get.”

Aldridge was not alone in having to fire-fight the rumours that swept the market that day and dragged the FTSE 100 down to its lowest level [in a decade]. Both Invensys – whose share price dropped 17% on Thursday before recovering on Friday – and Vodafone – which hit a four-year low of 79p – were forced to issue stock exchange statements saying there was nothing wrong with their accounts. Reed Elsevier, the publisher, also had to move swiftly to calm nerves when its share price dropped 5% following a court summons by activists questioning its accounts. The share price closed marginally up on the day but only after reassuring words from Crispin Davis, the chief executive.

For a while last week it looked like the market was staring into the abyss. Still spooked by the revelation last month of WorldCom’s $3.8billion (£2.5billion) accounting fraud, investors now appeared to be in full flight …

> The new fear was contagion – worries over the reliability of company accounts spreading like wildfire around the globe, but having their roots in the mood of deep underlying pessimism on Wall Street. A plague of uncertainty appeared to be spreading. “The big swinging dicks have never been gloomier,” said one financial-market regulator. “Their fear is that we are going to have at least six more months of this, with new accounting scandals appearing with monotonous regularity.” …
>
> While tens of thousands of small investors grimaced as the market slid last week, Britain’s financial institutions worriedly checked their books. When even the most solid of companies are seen as vulnerable, the virulence of this particular plague is put into sharp focus.
>
> (*Sunday Times*, 7 July 2002 (edited and updated 2015))

INTRODUCTION

This opening vignette captures nicely a number of the themes that are central to this text:

- Accounting information is a very potent information source – it has the capacity to cause share prices of companies to rise and fall based on how the market interprets it.
- One of the most important user groups is investors (shareholders) and tens of thousands of these individuals and institutions eagerly await and respond to accounting information as well as to rumours and misinformation.
- Notice, too, mention of “concerns about accounting” and “worries over the reliability of company accounts”. Traditionally, accounting information has been thought of as “correct” and “accurate” with little scope for imagination on the part of the preparers. It was, after all, a numerate discipline – so it had to be correct! More recently, however, it has become obvious that accounting rules allow considerable scope for subjective judgements to be employed by accountants and management. Indeed, it is now accepted that accounting practice owes more to a political process in which various interest groups lobby for their preferred treatment than it does to the discovery and implementation of any scientifically objective set of accounting rules. This in turn has focused attention on the regulation of accounting and the need for a more mature understanding of the various factors that contribute to the formulation of accounting information and regulation. An appreciation of these factors – in particular, the political nature of accounting regulation – will also be a central theme of this book.
- The article concludes with reference to a fear of “new accounting scandals appearing with monotonous regularity”. In fact, one of the key

issues accounting has had to face over recent decades is the impact of numerous frauds and corporate collapses that could be traced, in part, to accounting and auditing failures. Compounded by a perception that accounting rules played a role in the recent international financial crisis that saw the collapse of many banks and financial institutions, the credibility of accounting information has been challenged like never before.

IMPACT OF ACCOUNTING INFORMATION

While its role is constantly under the spotlight, accounting information remains a vital component of the information flows that underpin modern commerce and society. It can influence, for example, the manner in which wealth is measured and, as a result, how it is distributed amongst competing interest groups. This applies not only to local concerns such as wage negotiations, but also to macro-economic challenges such as wealth allocation between developed and developing worlds.

The following are a few examples of how accounting information and choices can impact on companies, investors, employees and society in general:

1. Modern commercial society depends on the efficient allocation of capital and good financial reporting assists this:

IN PRACTICE

Why do we care about financial reporting?

Put simply, we care because capital is the engine of our economy, and information is the oil that keeps the engine running smoothly. It is on this premise that the entire disclosure framework of our securities laws rests. The assumption – and I think it is a good one – is that providing information on which sound investment decisions can be made is the best way to allocate the scarce resource known as investment capital. In an efficient market, capital will seek its highest use. It is, therefore, not an overstatement to say that without good information our markets could not function effectively.

Source: www.sec.gov/news/speech/spch090303cag.htm

Give investors access to all the information they need, by Michael Bloomberg and Mary Schapiro

The most valuable currency in financial markets is reliable information. Without it, investors are unable to make informed decisions about where to allocate their capital which hurts companies' ability to attract it and

> puts a drag on economic growth. Transparency is an economic engine. For decades, investors' decisions have been aided principally by financial statements …
>
> Source: *Financial Times*, 20 May 2014

2. Accounting rules can have a direct impact on how individuals and companies behave. For instance, recent changes to accounting rules in relation to pensions had a very big impact on how companies viewed their pension policies (see Chapter 12). Other examples abound:

> **IN PRACTICE**
>
> ***Are the legions of standard setters out of step? by Richard Tyler***
>
> Williams Grand Prix Holdings last month blamed the onerous [disclosure] requirements of the International Financial Reporting Standard 8 for its decision to choose Frankfurt over London for its stock market flotation. Adam Parr, the executive chairman, told *The Sunday Telegraph*: "We have confidentiality provisions, not just with Formula One, but with partners that would just make that impossible."
>
> Warren East, chief executive of Britain's leading microchip technology group, ARM, tells me he faces another seemingly daft dilemma. His company is sitting on hundreds of millions of pounds in cash that he would be investing in fledgling technology companies if it were not for the accounting treatment of such deals …
>
> Source: *Sunday Telegraph*, 6 March 2011

3. Accounting information is the primary source of information for many service providers. Rating agencies, for instance, are heavy users of the financial information published by public companies. It is, according to Standard and Poor's – one of the leading credit analysts in the world – "the lifeblood of their business". These ratings will, in turn, directly impact the debt funding capacity and profile of many companies.
4. At a very basic level, accounting information performs a fundamental stewardship role, ensuring that items are tracked and accounted for in a very explicit and definitive manner. The failure of accounting at this level can have very practical impacts:

IN PRACTICE

MoD has mislaid £6.3bn worth of armed forces' kit, claim MPs, by Tom Coghlan

The Ministry of Defence has lost track of £6.3 billion worth of assets, a parliamentary committee said yesterday. The Defence Select Committee said that firearms, weapons systems and about 13 per cent of the Army's most modern radios, worth £184 million on their own, were among the equipment that cannot be accounted for.

They warned that the accounting discrepancies undermine calls by military chiefs for funding to sustain operations in Afghanistan and Libya. "It is alarming that the department should be unaware of the location, usability or indeed the continued existence of assets to a total value of £6.3 billion," the report said. It said that at almost a third of MoD stores, stock did not match inventories.

… The MoD said that £568 million of the assets unaccounted for included firearms and weapon systems, but it could not provide more specific data. … Sources at the MoD said they believed that the vast majority of equipment remained somewhere within the system. "We have this kit, we just don't know where it is," said one source. "The systems are just not in place to account for them."

… Among changes at the ministry will be new rules on financial accountability for the individual services while the creation of a Defence Board will seek to bring Armed Forces procurement programmes under control …

Source: *The Times*, 5 July 2011

5. Analysts and fund managers are key consumers of accounting information. Working for investment firms, banks or brokers, they effectively mediate between companies and other users such as shareholders, investors or the market. One of their most important sources of intelligence is financial accounting information and their confidence in it is a critical component of a healthy financial market.
6. The impact that accounting information has is apparent from the manner in which it can often materially and immediately move the share price of a company. As the following extract highlights, accounting measures, such as profit, are critical in determining share price. If a company warns that profits will not meet expectations, the impact on share price is usually immediate and negative:

IN PRACTICE

Boohoo shares are down 40pc after profits warning, by Graham Ruddick

Questions about the profitability of online retailers have reared their head again after Boohoo.com issued a major profits warning and saw its share price slump 40pc.

While online sales may be soaring in the UK, the US and elsewhere, profits have not followed. Online retailers including Asos, Ocado, AO.com and even the biggest of them all, Amazon, have all been dogged by questions about how much money they make.

Asos's share price is down by two-thirds in the last year, Ocado is yet to post an annual profit despite launching in 2000, and Amazon's market value shrank by a quarter last year.

Source: *Daily Telegraph*, 7 January 2015

These examples testify to the importance of accounting information in a variety of contexts. This importance has been achieved over many centuries as accounting and accountants have gradually assumed a critical importance in the commercial world and the information flows that underpin it.

HISTORY AND DEVELOPMENT

Accounting has been described as the language of business. While this may sound a rather extravagant claim, it does express something of the importance of accounting in today's world. For example, without accounting data much that is taken for granted in our society, from simple calculations of profit to the operations of international stock markets, would be impossible.

The manner in which accounting is practised today is a consequence of mankind's attempts to control the environment. Indeed, since earliest times people have felt the need to record events, and the emergence of some form of written record coincided with the development of basic recording skills. About 5,000 years ago writing and numbers were developed, and with the large increase in trade and the growth of centres of habitation in the Middle East came the need to record financial events. As the following extract illustrates, excavations in modern-day Iran, Iraq and Egypt have uncovered evidence of the use of clay tablets as one means by which crude records were maintained around this time:

EARLIEST KNOWN WRITING UNCOVERED IN EGYPT

Suhag Province, Egypt – Clay tablets just unearthed from the tomb of Egyptian King Scorpion I represent what is claimed to be the oldest discovered evidence of writing. German archaeologists say carbon dating places the age of the tablets at 3,300–3,200 BC. More than two-thirds of the translated hieroglyphic writings, on small pieces of clay tablets and the sides of jars, are tax accounting records.

(www.acaus.org/history/hsanc.html)

By the first century BC the need to account for wealth had developed to such an extent that the term "auditor" (a term still used today) had been adopted by the Romans to describe an individual who carried out such a task.

Accounting, therefore, emerged very early in the human record. This suggests that accounting for events is a basic social need. When people begin to organize they discover that accounting information is necessary for social control. It also demonstrates that accounting develops in response to human needs; that is, accountants adapt their systems to accommodate social developments. Today this principle still applies, with accounting constantly being adapted and modified in response to the changing needs of business and society. Contrary to popular belief, therefore, accounting is not an immutable science that possesses some absolute truths just waiting to be discovered by diligent researchers. It is a social discipline that responds to the needs of the society in which it functions. This is an important insight and informs the text throughout.

Another important thing to note is that one of the consequences of recording financial events is that those who do so begin to play a key role in the allocation of wealth. For example, it is accountants who define and calculate profit, one of the parameters for the division of wealth in modern society. It is this that gives accounting as a discipline and accountants as a profession such importance and ensures that those involved in business and management must understand how the accounting system operates.

Early modern developments

The origins of modern accounting and bookkeeping can be traced to the late Middle Ages when increased trade led to the need to account for profit and wealth. Gradually the method of accounting began to be standardized. In Venice in 1494, a monk and friend of Leonardo da Vinci, Fra. Luca Pacioli, produced a text, "*Summa de Arithmetica, Geometrica, Proportioni et Proportionalita*" ("Everything about Arithmetic, Geometry, and Proportions"), which contained

a treatise on bookkeeping entitled "*Particularis de Computis et Scripturis*" ("Details of Accounting and Recording"). This was an outline of the mechanics of the double-entry bookkeeping system that had been used for several decades in and around Venice. Over five centuries later this system remains the basis of modern bookkeeping.

IN PRACTICE

No accounting skills? No moral reckoning, by Jacob Soll

In Renaissance Italy, merchants and property owners used accounting not only for their businesses but to make a moral reckoning with God, their cities, their countries and their families. The famous Italian merchant Francesco Datini wrote "In the Name of God and Profit" in his ledger books. Merchants like Datini (and later Benjamin Franklin) kept moral account books, too, tallying their sins and good acts the way they tallied income and expenditure.

One of the less sexy and thus forgotten facts about the Italian Renaissance is that it depended highly on a population fluent in accounting. At any given time in the 1400s, 4,000 to 5,000 of Florence's 120,000 inhabitants attended accounting schools, and there is ample archival evidence of even lowly workers keeping accounts.

This was the world in which Cosimo de' Medici and other Italians came to dominate European banking. It was understood that all landowners and professionals would know and practice basic accounting. Cosimo de' Medici himself did yearly audits of the books of all his bank branches; he also personally kept the accounts for his household. This was typical in a world where everyone from farmers and apothecaries to merchants – even Niccolò Machiavelli – knew double-entry accounting. It was also useful in political office in republican Florence, where government required a certain amount of transparency.

Source: Jacob Soll, *The Opinionator*, 27 April 2014

The Industrial Revolution

The Industrial Revolution, particularly as experienced in Britain, changed the scale of business enterprise. Up to this point most businesses had been small family concerns. However, in response to investors' needs, new business entities called joint-stock (or "limited") companies emerged. These enabled a large number of individuals (called shareholders) to invest in a way that allowed them to limit potential personal losses. However, because it was impossible for all shareholders to be involved in the management of these limited companies, they usually appointed directors to manage the company on their behalf.

This meant that shareholders often knew very little about what was happening in their own companies. As a consequence the financial statements summarizing the company's performance became very important since only by understanding them could shareholders discover how their own money was being used.

The twentieth century

The demand for accounting information increased dramatically throughout the twentieth century, driven not just by the requirements of international trade and global capital markets, but also, ironically, by the information demands of two world wars. And as the need for financial information increased so did the influence of accounting and the accounting profession. The accounting function is now seen as a critical element of any developed, liberal, capitalist society, providing much of the information on which the financial and corporate worlds depend.

The advent of computers, the Internet and mobile technologies – the "Information Age" – have merely accentuated the importance of accounting information since financial data is now so prevalent and easily accessible that it has become one of the most powerful means of communication in the modern world. The new millennium, therefore, brought both challenges and opportunities.

Accountants have not navigated the early part of the twenty-first century well. A series of frauds and auditing scandals followed by the international financial crisis, for which accountants were held partly to blame, has seen the supremacy of accounting information challenged both conceptually and substantively. Accountants now find themselves having to explain and justify more cogently the rationale behind their outputs, their huge fees and the continuing need for accounting information to be privileged by society in the manner it has for centuries.

FORMS OF ACCOUNTING INFORMATION

Those not familiar with accounting information will usually have the view that it is not only based on numbers, but also, because of that fact, is somehow "accurate". In fact, while it is true that numbers are the primary form of expression of accounting information, this bestows neither intrinsic accuracy nor "correctness".

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The push for greater transparency and reduced risk is increasing corporate dependence on performance measurement and management tools, by Lesley Meall

But how meaningful is the information they provide? The devil is in the detail

During a month-long doctors' strike in Israel in 1973 the death rate dropped 40%; 3.7m Americans claim to have been abducted by aliens; 80% of the cars found on Albanian roads were stolen elsewhere in Europe; in India 30% of the population have not heard of the USA; in 1997, 39 people visited the accident and emergency departments of UK hospitals because of incidents involving tea-cosies; 65% of CFOs say their main focus is measuring and monitoring business performance; 43.3% of statistics are meaningless.

We are obsessed with counting and measuring anything and everything we consider of potential value. Businesses, investors, and politicians all argue their corner, and plan for their futures, armed with as many supportive statistics as they can muster. When this means counting the number of DVDs Amazon has sold in Australia, or calculating the annual revenue of Nissan Europe, it is all very well. But when you start trying to measure the popularity of George W Bush, the performance of the Blacklow Brow Primary School, or customer satisfaction at Starbucks, then just how meaningful can the results possibly be?

James Anyon, a UK accountant who was one of the founding fathers of US accounting, steadfastly warned the profession against such antics. "Use figures as little as you can," he told accountants at the turn of the [twentieth] century. "Your client doesn't want them or like them, he wants brains." A hundred years on Anyon is probably turning in his grave. "Think and act upon facts, truths and principles," he advised, "and regard figures only as things to express these."

Source: *Accounting and Business*, July, 2004

Because of the inherent limitations of numbers, accounting information is increasingly being supplemented by, and indeed expressed in the form of, narrative communications. These can range from supplementary commentary on specific accounting numbers, to more complex and comprehensive presentations and discussions of accounting data. The form in which this mix of narrative and financial information is most obviously available is the annual report.

ANNUAL REPORT

Accounting information can be presented in a variety of formats, usually depending on the particular users in mind. For example, managers will often be presented with large amounts of financial detail in the form of budgets that enable them to plan and evaluate performance. Other forms of presentation include internal reports, asset schedules and forecasts. Information such as this is usually termed "internal" accounting information because it is intended primarily for use by management to assist in the efficient running of an organization.

The other principal category of financial information can be termed "external". This is because it is intended primarily to satisfy the statutory and public accountability responsibilities of a reporting entity whereby it releases information for more widespread consumption. The prime example of this type is the annual report. This is a statutorily required document which each UK company listed on the London Stock Exchange must issue, normally every year. And it is also the primary focus of this text – the skills and insights provided over the course of the following chapters are intended to enable the analysis and interpretation of this document with a view to gaining an understanding of the company in question.

Typically an annual report will include:

- accounting information:
  - statement of financial position (previously the "balance sheet");
  - income statement (previously the "profit and loss account");
  - cash-flow statement;
  - notes to the accounts.
- narrative reports:
  - directors' report;
  - chairman's statement;
  - auditor's report;
  - other reports, such as the new strategic report.

As a principal means by which a company communicates with the various constituencies to which it is accountable, the annual report comprises a unique source of information about the company. Not surprisingly, therefore, it is the subject of considerable and detailed analysis, comment and criticism.

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In recent years the length and unwieldiness of the annual report document has attracted particularly negative comment.

FRC tackles reporting "clutter", by Raymond Doherty

James Roberts, audit partner at BDO, said the guidance was "timely and important". "Corporate reporting should be the currency of trust in capital markets but this trust is being steadily eroded. In Genesis, God created heaven and earth in less than 1,000 words. So why should the length of just the corporate governance section in one company's annual report be 14,000 words? Companies need to demonstrate risk and opportunity in a clear, simple and concise manner. Risk will always be present, but good reporting must reduce it, and be of real value to investors and also to companies competing to attract funds," he added.

Source: *Economia*, 9 June 2014

Short is sweet

Be honest, be clear, be done with it. As columnists know, a word limit focuses the mind and helps the reader.

Lehman Brothers' 2007 annual report was a long, but not Proustian, 132 pages. Then the bank went bust. And most banks' 2007 reports contained little hint of their exposure to the US housing market, or indeed their true leverage. Regulation rightly changed to increase transparency. And banks added pages, hoping to placate both investors and lawyers.

So annual reports have inflated prodigiously. Some of the new information is useful – disclosures about financial instruments and board remuneration are better now. But a 598-page report (HSBC's last annual report/bludgeon, for example) is a barrier to understanding. Just because something is disclosed doesn't mean it wasn't lost in a mass of detail.

Readers should be congratulated (and then resuscitated) if they make it to the end of a modern report. But they still might not understand the business. Keeping an annual report succinct forces preparers to focus on what matters. If a business truly requires 600 pages to describe its operations, then it is too complex for an outsider to invest in (whether it is too complex to manage is a separate question).

Two recent UK Financial Reporting Council projects present recommendations for more concise reporting. The FRC is not proposing new rules, though it recommends cutting clutter and focusing on the audience, but it is short on specific proposals for what should be cut out.

> And, indeed, rules cannot solve the problem. What is important varies by company and industry, and knowing what is important requires judgment and cannot be standardised. Setting a limit, of, say, 40 pages in 12 point font would be mad. Instead, regulators and companies must recognise that disclosure does not cleanse all sin.
>
> If the crucial point appears on page 423, it is concealed. And the company is accountable for that.
>
> Source: *Financial Times*, 13 November 2014

As the following account indicates, accountants and regulators have sought to respond to these criticisms in a variety of ways. On the one hand, while accommodating increasing information demands from government and others, they have sought to reduce the size of reports by streamlining requirements. On the other, they have sought to encourage companies to produce reports that are accessible to a variety of stakeholders, while emphasizing that the annual report should be "fair, balanced and understandable".

FINANCIAL REPORTING COUNCIL WANTS CLEAR AND CONCISE ANNUAL REPORTS, BY JILL TREANOR

The Financial Reporting Council is publishing new guidelines to help reduce the size of long and complex annual reports. Top companies are being urged to produce clearer and more concise information to describe their strategy to investors in a move intended to reduce the amount of verbiage in annual reports.

The Financial Reporting Council, which oversees corporate governance codes and accounting standards, is publishing new guidance to help reduce the size of annual reports, which can run to hundreds of pages and contain sections on remuneration, financial statements and the directors' report.

The new section containing a strategic report has been introduced since October and Melanie McLaren, executive director Codes and Standards at the FRC, said it should be concise enough to be read over a "decent cup of coffee". The strategic report is intended to cover the business model and the risks the company faces.

Companies have been duplicating information in annual reports – their yearly report card for their shareholders – between the different sections and the FRC is now arguing that there can be more cross-referencing of information.

> Since 2012 the FRC has required corporate reports to be fair, balanced and understandable. Stephen Haddrill, chief executive of the FRC, said: "However, investors still express concern that the key messages about the business are buried in too much verbiage of little value or are obscured by boilerplate. The programme we launch today is designed to tackle this persistent problem and promote clear and concise reporting. We will be seeking the views of stakeholders through roundtable discussions."
>
> (*Guardian*, 9 June 2014)

There are, of course, other types of financial information available such as analysts' reports, prospectuses, interim reports, preliminary announcements and media comment. These supplement the information available in an annual report and allow a more holistic, comprehensive and contextual understanding of companies and their performance. However, the focus of this text remains on the annual report.

USERS OF ACCOUNTING INFORMATION

The critical role that accounting plays in the liberal democratic market economies that predominate in today's developed world is reflected in the number and range of users of that information:

- *Shareholders and investors*: Because of their large numbers, shareholders are not normally involved in the running of the business. For this reason it is particularly important that they receive prompt and accurate accounting information about their business so that they can assess how it has performed. The annual report has traditionally been intended to satisfy the information requirements of this group. Ironically, the need to address an ever-increasing range of users as well as the impact of financial scandals may have had a negative effect on the quality of some of the information disclosed.
- *Financial analysts*: Accounting information is prepared and presented in accordance with various regulations, concepts and terminology. Like any other language it is often incomprehensible to those who have not learned how to read it. Analysts and fund managers play a key role in mediating between the preparers of accounts and those who need to understand them. They advise existing or potential shareholders such as insurance companies, pension funds, investment trusts and individuals, and are among the most sophisticated users of accounting information.
- *Management*: Management, who will have access to all accounting data within a business, will be one of the principal users of accounting

information. They will use it to assist them in checking past performance and in making decisions about the future activities of the business.

- *Employees*: Accounting information is relevant to employees since they will want to know whether or not the company can offer safe employment and promotion. In recent years, with the advent of share option schemes and substantial numbers of shareholding employees, the relevance of accounting information to employees has taken on a new dimension.
- *Lenders*: Lenders' primary concern is the security of their loans, so they will analyse the financial statements to determine whether the business will be able to repay amounts due. They will be particularly interested in the availability of cash and the value of any assets given as security against loans.
- *Taxation authorities*: HM Revenue & Customs use accounting information as a basis upon which to determine tax liability.
- *Others*: Increasingly members of the general public or pressure groups such as environmental protection organizations are using accounting information to pressure companies into changes in their operating practices.

SUMMARY

If accounting is a language, indeed a highly technical language, then financial analysis – the focus of this text – can be seen as a means of interpreting that language and of reducing it to more manageable concepts and expressions. It also acts as a mediating influence in disseminating information about commercial entities to a broader range of users.

In order to interpret it properly it is necessary to understand some of the influences that shape both its form and the role it plays in modern society. This is the focus of Section I.

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Section I

CONTEXTS

One of the principal emphases of this text is that it is necessary to inform any interpretation of accounting information with as broad and rich a contextualization as possible. To coin a phrase, the three most important factors in enabling an informed understanding of accounting information are “context, context and context”.

For this reason Section I is devoted to a discussion of four contexts that must be considered before any analysis and interpretation of accounting information is possible.

Chapter 1 looks at the regulatory frameworks that underpin accounting practice. The notion of accounting as the product of a “political” process is introduced. This is understood to mean that accounting rules result from a dynamic in which various interest groups, such as professions, governments or others, compete to influence the decisions of regulators. If true, then this means that accounting regulations must be seen as deriving from political choices and preferences, rather than from laboratory-style research that somehow reveals “correct” and immutable schemes of accounting practice. This has major implications for any analysis of the information content of financial statements.

Chapter 2 develops the notion of accounting as a critical means of communication, albeit one that is still struggling to develop a set of unified principles and thought that would act as a base from which a more coherent and integrated set of practices might emerge.

Accounting information is, in many senses, simply a commodity. Chapter 3 extends the discussion, therefore, to further explore the question “What is the role of accounting information in modern society?” Focusing specifically on the role of accounting information in the stock market, it looks at various theoretical

approaches that seek to answer this question. It also places this discussion in the context of the recent global financial crisis where the limitations of a "market-based" approach were exposed and the role of accounting information and regulation more clearly seen.

Having explored the role of accounting information in the market, Chapter 4 changes the focus to the impact of corporate structure on the role and form of accounting information. Tracing the historical and commercial considerations that have resulted in the unique form of corporate governance that predominates in the Anglo-American world, this chapter considers the impact this has had on the nature and accessibility of accounting information.

CHAPTER 1
REGULATORY CONTEXT

When you have completed this chapter you will understand that:

- accounting is closely regulated;
- various entities, including governments, international organizations, capital markets and accountancy bodies, have a role in the regulatory process;
- regulation was previously country-specific, but is now more international in orientation and ambition;
- the influence of accounting standard setters such as the International Accounting Standards Board (IASB) has increased significantly in recent years;
- one way in which the regulatory role of governments is expressed is through legislation and this impacts directly upon accounting information and its disclosure;
- stock-exchange rules represent another source of regulation;
- there are detailed provisions relating to the formation of a company in the UK;
- regulation and legislation impact on the information to be disclosed in the annual report;
- one of the big drivers of increased regulation is a reaction to the "light touch" approach that preceded the financial crisis.

WHY THE PENDULUM SWINGS; THERE IS A TIME FOR TIGHT FSA RULES AND A TIME TO EASE OFF, SAYS CARLY CHYNOWETH

Regulation is a cyclical beast: a crisis of one form or another leads to tighter rules, but over time politicians decide it would be more beneficial to loosen

the reins and give business more room to grow. Eventually there will be another crisis and it all starts again.

"Think of regulation as a large swinging pendulum," says David Kenmir, who is now a director at PwC after two decades at the Financial Services Authority (FSA), the regulator. "After every financial crisis, be it global or sectoral, regulators look to learn lessons and generally look to tighten the regulatory framework. Inevitably industry does not like it. Gradually, however, the Government will start looking for ways to make life easier for business, for example by cutting red tape, and regulatory regimes start to loosen again."

This effect can be seen neatly in changing perceptions of the FSA. During the boom years it was praised for its light touch, which helped to make London a global financial centre. When things went wrong, it was criticised for this characteristic. "Regulators make a convenient target when things go wrong," Kenmir says, adding that while they make a difference, they will always be at a competitive disadvantage when compared with the huge, well-paying institutions they regulate.

Given this cyclical pattern – and the serious nature of the recent financial crisis – it is hardly surprising that financial institutions are facing heavy scrutiny and strict regulation. "This particular pendulum has swung farther than most," Kenmir says.

He believes that businesses will be operating under a particularly burdensome regulatory regime for the next five or ten years. The pendulum will start to swing back when we begin to see the effect that the regulators' demands for extra liquidity and capital, designed to prevent or mitigate future problems, have on the economy. If it stifles growth, politicians will start to loosen regulations again.

It is also possible that, in focusing on the most recent crisis and developing rules with that in mind, regulators unwittingly could create conditions for the next crisis … "It is like squashing a balloon – one bit goes in and you get a bulge somewhere else."

The other thing that has changed is the way in which firms and regulators think about risk. "There is an ever-growing industry of enhancements to risk management that are demanded by boards, who want their shareholders to know that they are looking closely at the issue," Kenmir says.

For example, there has been a growth in the number of companies with a chief risk officer. But it is not so much that the risks have changed as business's perceptions of risk. Businesses always knew there was a risk that the liquidity market could dry up, as happened in the crisis, but no one believed it would happen, Kenmir says.

Another interesting feature of the most recent crisis is that the international response has been much more coordinated than in the past; sometimes it seems like the G20 group talks of nothing else.

"There is also much more of a move towards international standard-setting, although, as always, the problem tends to come in how regulations are interpreted at a domestic level," Kenmir says …

(*The Times*, 19 January 2011)

INTRODUCTION

Accounting information is a key feature of international business, and, as such, it finds itself at the centre of an ongoing debate between regulators and politicians, between business and social interests. Essentially the question is, "How and to what extent should accounting be regulated?" As this opening vignette suggests, regulation is often cyclical in nature: the "light touch" approach of recent decades has been replaced by demands for much tougher regulation in the wake of the international financial crisis.

The debate has also been impacted on by dynamics such as globalization, while technological advances have forged new contexts within which accounting regulation must be assessed. Traditionally considered in far less ambitious terms, the realization that accounting is a critical means by which businesses communicate allows it to be viewed as one element in an ongoing struggle between proponents of laissez-faire ("unregulated") market economics and those more alert to the potential for volatility and inequality in an unregulated economy.

Accounting regulation must, therefore, be viewed in a variety of contexts. Only this approach allows the reasons for, and the agents of, its regulation to be properly understood.

For much of the twentieth century government intervention and professional regulation were viewed as generally benign and disinterested influences. The result was the development of a complex regulatory process for accounting that embraced the law, governments, the profession and various other interested parties.

The latter decades of the twentieth century, however, witnessed something of a reaction to this view. The Thatcherite revolution in Britain and the Reaganite years in the US generally espoused a laissez-faire culture that sought to reassert the role of the market as the primary means by which information flows should be determined. In the process, champions of this approach sought to disengage the government and its regulatory tentacles from functions more properly considered the domain of the market.

However, while the market-based focus of recent decades has caused some reconsideration of the nature and extent of the regulatory process, it is still the case

that the traditional parties such as government and the accounting profession heavily control the preparation and dissemination of accounting information. This reflects the importance and significance of accounting information in modern society.

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There is widespread contention between proponents and opponents of increased regulation as a means of dealing with many of the governance and accounting issues raised by recent scandals and the broader financial crisis. However, in the interim, as the following extract illustrates, attention to various regulatory requirements is consuming vast amounts of corporate resources.

Regulatory changes tie up CFOs, by Raymond Doherty

Executives at UK financial services firms are spending 18% of the week, approximately one day, dealing with changing regulatory requirements, a new study has revealed

The amount of time has increased significantly in the last three years, with 59% of executives surveyed saying that they spend either "more" or "significantly more" time on global and local regulatory matters.

The survey by recruitment consultancy Robert Half of 50 chief financial officers and 50 chief operating officers, showed that executives are facing the challenge of managing this barrage of regulatory change without strong support from their teams.

Four in ten said that their teams are "not very" or "not at all" knowledgeable about all the regulatory changes. Those who are least knowledgeable are medium sized companies (50%) followed by small companies (39%).

UK departments are less knowledgeable than some of their global counterparts: 89% of CFOs and COOs in Hong Kong say that their teams are "somewhat" or "very" knowledgeable followed by 82% of peers in Germany and 70% in Singapore.

Neil Owen, global practice director, Robert Half Financial Services said that, "senior financial services professionals face a real dilemma" as they have "no choice but to manage the huge workload that regulatory change represents, but also find that their teams lack the necessary knowledge to keep their companies on top of it all."

He believes this is having a "severe impact", consequently "it's not surprising that we are seeing such a big demand for interim and permanent financial services staff with proven regulatory compliance".

Source: *Economia*, 4 September 2012

REGULATORY FRAMEWORK

In an accounting context, the regulatory framework describes that system of rules and principles that controls and shapes the nature and content of financial information. In the context of this text, this relates, in particular, to the manner in which regulation impacts upon the information disclosed in the annual report.

Because of its critical importance in modern society, financial information has always attracted the attention of regulators. This has been true especially since the early years of the twentieth century. At that time the need to streamline and harmonize the flow of accounting information became apparent, particularly in the US, as the potential for accounting information to influence decisions of great importance became clear.

The first part of this chapter outlines the regulatory apparatus as it has emerged in the Anglo-American world. It begins with an examination of the system that applies in the US, a model that has influenced the regulatory process in much of the developed world. It deals subsequently with the regime applying in the UK. It then looks at the emergence and increasing importance of the International Accounting Standards Board (IASB). The second part of the chapter deals with the legislative context.

US

One of the catalysts shaping the regulatory environment of the twentieth century was the crash of the Wall Street stock market in 1929. In the reaction to the supposedly unregulated market that was identified as a significant factor in this crash, the Roosevelt administration embarked upon a National Recovery Programme, known as the New Deal. This had as one of its core principles the need for greater regulation of capital markets. This was in line with the general thrust of US government commitment to control via regulation, as distinct from the interventionist model that led to extensive nationalization in contemporary Europe.

As part of this process the US government set up the Securities and Exchange Commission (SEC) and charged it with the task of regulating both the stock market itself and its constituent parts, one of which was the financial reporting process. As evidence of its seriousness the government appointed Joseph Kennedy, father of the future president, and soon to be ambassador to Great Britain, as the SEC's first chairman. When critics objected that Kennedy was a notorious speculator and opportunist and, therefore, not suitable, Roosevelt replied that these were the very credentials needed for the job.

Prior to the inauguration of the SEC there were little or no standards governing the content of corporate financial reports. The scope that this gave companies to produce financial reports to suit their own purposes was identified

as a critical feature of the laissez-faire regime that had precipitated the crash. Under the Securities Act (1933) and the Securities Exchange Act (1934) all companies whose securities were traded publicly were required to file reports with the SEC. This had the effect of imposing a certain level of uniform disclosure on companies, intended to provide investors with the information necessary to make informed decisions about their investments.

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Recognizing the vast range and nature of financial information that companies are now required to publish and submit in the wake of various regulatory initiatives, SEC is using novel risk-assessment approaches in order to enforce its regulatory mandate (technical terms will be covered in later chapters).

SEC enlists Robo accountant in battle against company fraud, by Adam Jones

US finance chiefs beware: accountancy's answer to RoboCop will soon be watching you. The Securities and Exchange Commission is deploying a computerised tool designed automatically to trigger alerts over suspicious accounting at publicly traded companies.

The regulator plans to roll out the early warning system this year, saying it will mine a "rich vein of information" continuously supplied by companies through official filings such as annual reports …

The data mining software is partly based on a model the SEC developed to trawl through hedge fund returns for signs of Madoff-style chicanery. The accounting version will analyse whether a company "sticks out from the pack" in areas such as accruals, which are non-cash entries that can be manipulated by management.

Other factors that might raise red flags include a high proportion of off-balance-sheet transactions, frequent changes in auditor and delays to earnings announcements. "When firms are choosing accounting treatments that are unusual – that's something we would like to highlight [for SEC examiners]," said Mr Lewis, a former finance professor who is also the SEC's chief economist.

Tracking such practices will primarily give the SEC a sense of the riskiness of a particular company relative to peers. Mr Lewis hopes the system will flag up the odd crime too: "My hope is that we'll turn over a number of accounting fraud cases."

Source: *Financial Times*, 14 February 2013

Directly answerable to Congress and, therefore, operating within the political system, the SEC has developed into one of the most effective and potent regulatory agencies in the US. It comprises five commissioners, one of whom acts as chairman, and has a team of lawyers, accountants, analysts and others who monitor the companies under its aegis. In all a staff of over 4,000 monitors the 13,000 public companies within its remit. (There are almost 4 million US corporations in all.) A system of heavy penalties ensures that much of the onus for securing compliance is placed directly upon companies themselves and their financial advisors.

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For more on the SEC see www.sec.gov. You should also access the EDGAR facility (www.sec.gov/edgar/searchedgar/webusers.htm) to view the vast number and range of submissions that US public companies must make.

Although it has occasionally issued standards, the SEC has been content to delegate to the private sector the task of determining generally accepted accounting principles (GAAP). In this process the American Institute of Certified Public Accountants (AICPA), as the pre-eminent accounting body in the US, has played an important role. In 1939, having worked closely with the New York Stock Exchange on a number of mutually important issues, the AICPA established the Committee on Accounting Procedure and the Committee on Accounting Terminology. These were crucial in developing a culture that recognized the importance of a uniform set of accounting practices devised by the accounting profession. Between 1939 and 1959 these committees issued 51 Accounting Research Bulletins that, to a limited extent, represented a broadly acceptable code of accounting practice.

By the late 1950s, however, the flaws inherent in a system that merely issued pronouncements in response to problems as they arose, as distinct from promulgating a set of principles that might form the basis on which to generate a more coherent GAAP, had become apparent. In 1959, therefore, the AICPA set up the Accounting Principles Board (APB) and the Accounting Research Division. These were charged with fostering an approach that would seek to establish just such a set of coherent, unifying principles, or theoretical framework. With limited success the APB pursued this agenda until 1973, by which time it was felt necessary to establish a new standard-setting regime.

Financial Accounting Standards Board (FASB)

FASB, which took over many of the functions of APB, is an independent body governed by the Financial Accounting Foundation (FAF) which itself comprises representatives of nine organizations, including the AICPA, the Financial Executives Institute, the Security Industry Association, the Financial Analysts Federation, various not-for-profit organizations and others. Apart from appointing the seven-member FASB and the members of the Financial Accounting Standards Advisory Council (FASAC), which advises FASB on its agenda, the FAF is responsible for generating funding for FASB as well as championing its role and its independence.

The stated purpose of FASB is "to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information." Implicit in this is recognition of the fact that the number and range of users of accounting information has been increasing, and that accounting information needs to address the interests of this broader constituency.

The role of FASB was reinforced when the SEC explicitly confirmed that "principles, standards and practices promulgated by the FASB will be considered by the Commission as having substantial authoritative support".

FASB differs from its predecessors in a number of ways:

- Its membership is smaller (seven), full-time, more independent and well-compensated.
- It is more autonomous from the accounting profession.
- There is no stipulation that it should consist only of members of AICPA.
- Passage of a standard requires only a super-majority, i.e. five out of seven in favour.

FASB issues two types of pronouncement: Statements of Financial Accounting Concepts (SFACs) which deal with fundamental accounting concepts and principles and provide a framework within which Statements of Financial Accounting Standards (SFAS) are formulated. While SFACs are critical in providing a coherent theoretical underpinning for accounting practice, only the provisions of SFASs are regarded as constituting GAAP.

One significant feature of FASB has been its sensitivity to social and economic changes that have highlighted the responsibilities of standard-setting bodies to an increasingly large range of users. This has been reflected not only in the make-up of the board, but also in the adoption of a more transparent due process through which issues are expected to pass before emerging as an SFAS. The stages in this process can be summarized as follows:

1. A topic is placed on the FASB agenda by FASAC or other stakeholders.
2. A task force is set up to identify the relevant issues.

3 The FASB technical section then investigates the topic.
4 A Discussion Paper/Memorandum is released seeking responses from the public.
5 Public hearings are conducted.
6 An Exposure Draft (ED) is released, followed by further consultation.
7 The ED is re-evaluated in the light of responses.
8. The FASB membership vote on the ED and issue a SFAS if a sufficient majority is secured.

One particularly potent element of the new structure was the establishment of an Emerging Issues Task Force (EITF). This group is charged with identifying potentially contentious issues and alerting FASB, as well as resolving technical issues. It has proved to be a very useful mechanism for dealing proactively with current issues before they have had an opportunity to generate too much confusion and disagreement.

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Asked if there was one thing he learned in 2000, FASB chairman Edmund L. Jenkins said: "I have learned that it is important to defend independent standard-setting, that you cannot take it for granted. You need to keep talking about the benefits of the capital market having sufficient information for investors to assess opportunities." With that lesson tucked in his syllabus, Jenkins expects to have FASB dedicate more time to political tactics in Washington. Unfortunately this will detract from efforts to fulfil the Board's real mission: to produce high-quality, non-partisan accounting standards.

Sarbanes–Oxley (SOX)

One of the principal legacies of the accounting frauds that embroiled the US in the early years of this century has been the huge raft of regulatory responses. These were undertaken by accounting bodies, professional institutes, government and others. Perhaps the most high-profile intervention was the Sarbanes–Oxley Act. Enacted by the US Congress as an immediate response to these frauds in 2002, and named after its two principal sponsors, it has significantly impacted on the nature and content of accounting disclosures by companies in the US and elsewhere.

While SOX focuses on closer regulation of various aspects of corporate activity, it introduced a greater focus on internal controls and compliance. This has significantly increased the nature and level of reporting on these areas. Indeed, cost/benefit analysis of the growing workload experienced by many firms (research suggests that compliance now consumes on average 1.25 per cent

of revenue for large US corporations) has led to resistance to the "creeping intrusion" that new regulatory requirements represent.

Public Company Accounting Oversight Board

One further piece of the regulatory architecture in the US is the Public Company Accounting Oversight Board (PCAOB). This entity was created to oversee the audits of public companies. This was seen as an important response to various frauds and audit failures and was intended to protect the interests of shareholders and other investors.

One consequence of the creation of the PCAOB was that, for the first time, auditors of US public companies were subject to independent, external oversight, a move intended to protect the public interest and a reflection of the suspicion with which the accounting profession and the audit function were viewed.

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That standard-setting is essentially a political process in which different groups lobby for their preferred outcome, rather than a scientific one in which "correct" accounting practices are "discovered" has already been alluded to. The following two extracts highlight different aspects of this dynamic. Notice, in particular, reference to audit failure; this will be revisited in Chapter 5.

The Big Four have been putting more money than ever into political lobbying, according to a report from Reuters, by Helen Roxburgh

Deloitte, Ernst & Young, KPMG and PwC spent a combined $9.4m in America last year on in-house and outside lobbyists according to the Reuter analysis of congressional disclosure reports. This is more than in any other year since 2002.

A significant portion of the Big Four's lobbying efforts in the US goes to trying to influence the Public Company Accounting Oversight Board, which is considering a number of reforms including the rotation of audit firms.

PwC chairman Bob Moritz told Reuters his firm's lobbying of the PCAOB is intended "to make sure we have a common understanding of the challenges that each of us faces," adding that "we are absolutely aligned in taking the profession to the next level".

A Deloitte spokeswoman said in an emailed statement that some of the firm's lobbying "relates to policy issues that are germane to the type of work we do for the federal government".

In 2011, Deloitte spent the most on lobbying at $3m, followed by PwC at $2.7m, Ernst & Young at $2.2m and KPMG at $1.5m.

Source: *Economia*, 12 March 2012

US Watchdog warns on auditor failings, by Tracy Alloway

The US's top auditing firms are failing to adequately sign off on some companies' accounting controls, the country's industry watchdog has warned in a report. Auditing firms such as Deloitte & Touche, Ernst & Young and PwC are required to approve companies' so-called "internal control over financial reporting" (ICFR) when they look over company statements.

However, the Public Company Accounting Oversight Board said on Monday that almost one in six of the firms' audits into internal controls did not do enough work to sign off company accounts.

About 15 per cent of the 309 audits examined by the board "failed to obtain sufficient audit evidence to support their ICFR audit opinions", the board said in a report that mainly looked at 2009 audits. For 2010 audits, which have yet to be completed, that percentage climbed to about 22 per cent.

"If auditors don't get the internal control piece right it is very likely that they will not get the financial statement audit right," Jeanette Franzel, PCAOB board member, said in a press conference.

Some 82 per cent of the more than one-fifth of 2010 internal control audits that failed to gather enough evidence also failed to sufficiently support financial statement audit opinions, the watchdog said.

Source: *Financial Times*, 10 December 2012

The regulatory regime in the US is robust, extensive and relatively effective. Characterized by government involvement as well as considerable input from accounting regulators and professionals, it favours a rules-based approach epitomized by the SOX legislation. This model has shaped the regulatory cultures of many others, especially English-speaking countries.

UK

In many ways, developments in the UK in the first half of the twentieth century mirrored those in the US. Not surprisingly, therefore, as had happened in the US some years previously, by the late 1960s it had become apparent that the requirements governing the presentation and disclosure of financial statements in the UK were inadequate. While accountancy bodies such as the Institute of

Chartered Accountants in England and Wales (ICAEW) made "recommendations" to members, accounting practice varied considerably.

At the initiative of ICAEW, an Accounting Standards Steering Committee was formed with a view to developing a set of accounting standards. By 1971 the Institute of Chartered Accountants of Scotland (ICAS), the Institute of Chartered Accountants in Ireland (ICAI), the Association of Chartered Certified Accountants (ACCA) and the Chartered Institute of Management Accountants (CIMA) had joined the project. In 1976 this committee was reformed as the Accounting Standards Committee (ASC) under the sponsorship of the Consultative Committee of Accountancy Bodies (CCAB), a group comprising the five original sponsoring bodies plus the Chartered Institute of Public Finance Accountants (CIPFA).

Accounting Standards Committee (ASC)

The ASC was charged with:

- defining accounting concepts;
- narrowing differences in accounting practice;
- formulating best practice.

By a due process, which involved a degree of consultation with representatives of other interested parties and the circulation of consultative documents called Exposure Drafts, the ASC made recommendations to the CCAB, which, if it approved them, issued these as Statements of Standard Accounting Practice (SSAPs). These were then binding on the members of the constituent bodies. Significantly, ASC and CCAB claimed to carry out these tasks "in the public interest", the presumption being that accountancy bodies were the ones most suited to fulfilling this role.

By the late 1980s, in the face of several high-profile corporate failures and the obvious incapacity of the part-time ASC to respond more quickly to pressing issues, CCAB appointed a committee chaired by Sir Ronald Dearing to review the standard-setting process.

The Dearing Report, issued in November 1988, contained a series of far-reaching proposals and recommendations. Specifically, it highlighted the need for:

- a standard-setting process which promoted compliance, reduced options and assisted interpretation by an emphasis on the production of standards that were based on core principles as distinct from the ASC approach of individual standards for individual issues;
- the development, following the model developed by FASB, of a coherent conceptual framework (see Chapter 2);
- a reduction in the requirements to be met by small companies;
- the gradual incorporation of public sector bodies within the framework.

In terms of structure, it recommended that overall responsibility be placed in the hands of a Financial Reporting Council (FRC) intended to guide the standard-setting process, ensure financing and act as a strong public champion of the standard-setting approach. It was to include representatives from a number of interested parties under the chairmanship of a joint nominee of the Secretary of State for Trade and Industry and the Governor of the Bank of England. Accounting interests would be represented by members from practice, industry and the public sector, but there would also be an equal number of representatives from other interested bodies, such as the legal profession and bankers.

Mirroring the US scheme, it was envisaged that the FRC would devolve the task of devising accounting standards to a new Accounting Standards Board (ASB) under a full-time chairman and technical director, supplemented by a full-time secretariat. To address the lessons learned from the ASC's inability to deal promptly with the vast array of emerging issues it was proposed that an Urgent Issues Task Force (UITF) be set up with authority to issue non-mandatory, but authoritative, guidance on matters requiring immediate attention.

Finally, to ensure prompt compliance, it was recommended that a Financial Reporting Review Panel (FRRP) be established to examine, with the support of the Stock Exchange, deviations from accepted accounting practice by large companies.

The Dearing Report received widespread support and the basic structure recommended was quickly put in place. The FRC, initially under the chairmanship of Sir Ronald Dearing, was established in 1990 as part of the stated determination of the government to ensure that corporate reporting and governance conformed to the highest international standards. In August 1990 the ASB, with David Tweedie as chairman, Allan Cook as technical director, and seven other members, came into being. This was followed shortly afterwards by the inauguration of the FRRP. The ASB, in turn, established the UITF.

Accounting Standards Board (ASB)

One of the priorities of ASB was to emphasize that, unlike its predecessor, it issued standards – called Financial Reporting Standards (FRSs) – in its own right. However, it was also anxious to avoid confusion over the status of SSAPs issued by ASC. As a result, it formally adopted the 22 extant SSAPs. It then set about issuing new standards in line with its stated aim to "establish and improve standards of financial accounting and reporting, for the benefit of users, preparers and auditors of financial information".

In pursuing this agenda, ASB decided to adopt policies designed to ensure that standards:

- were the product of a research and consultative process that is sensitive to issues such as usefulness, timeliness and the relative costs and benefits of the proposed standard;

- reflected national and international environments to the extent that they take cognizance of current UK law and EU directives;
- supported harmonization of international financial reporting;
- were clearly expressed and supported by a coherent analysis and rationale;
- resulted in information that *faithfully represents* the underlying commercial reality;
- reflected the desire for an evolutionary, as distinct from revolutionary, approach.

The procedure leading to the issuing of a standard closely followed the FASB model and reflected this determination to ensure as wide and informed a consultative process as possible.

Financial Reporting Council (FRC)

The recent financial crisis caused a review of the culture and structure of regulation of the financial sector. Previously, the Financial Services Authority (FSA) was responsible for the overall regulation of the financial services sector. The FSA was replaced under the Financial Services Act 2012 by a new Financial Conduct Authority (FCA), with the Prudential Regulation Authority (PRA) assuming other significant responsibilities.

This was paralleled by the elevation of the Financial Reporting Council (FRC) as the UK's independent regulator with responsibility for ensuring high-quality corporate governance and financial reporting standards. FRC incorporates entities such as the new Accounting Council and the FRRP, and is now the issuing authority for accounting standards in the UK.

IN PRACTICE

The cumulative effect of various additional regulatory interventions has been to significantly increase the financial and time resources being deployed by regulators as well as those being regulated. This reflects the change in culture following the financial crisis from a "light touch" approach to a more intrusive regime.

Regulators spend 60% more on enforcement, by Chris Newlands

Regulators in the US, Hong Kong and the UK have increased their enforcement expenditure by almost 60 per cent over the past seven years as they attempt to grapple with market abuse.

The US Securities and Exchange Commission (SEC), the UK Financial Conduct Authority (FCA) and the Securities and Futures Commission of Hong Kong (SFC) spent approximately $2.4bn in 2012/13, roughly

$900m more than in 2006/07, according to research from Kinetic Partners, the consultancy.

The rise will be unwelcome news for asset managers who have long complained of being overburdened by what they see as excessive and expensive regulation.

Julian Korek, chief executive of Kinetic Partners, said: "The focus on effective regulation in the financial markets is no surprise following the 2008 crisis. The public is demanding that government agencies take greater steps to protect the public interest, which requires regulators to expand both the reach and efficiency of their monitoring activities."

The percentage rise in expenditure was greatest in Hong Kong. The SFC increased its spend by 120 per cent over the past seven years, to $152m. UK expenditure grew 48 per cent to $870m, while the SEC increased its enforcement outlay by 61 per cent to $1.4bn.

The SEC, however, increased its staff count by just 22 per cent over the seven-year period, to 4,223, while the FCA raised staff levels by 53 per cent, to 3,992, and the SFC by 50 per cent, to 668. "It seems that the ratio of regulators to regulated persons is narrowing. We expect this trend to continue," said Kinetic.

Source: *Financial Times*, 26 May 2014

As this "In practice" insert notes, we are now in a period when greater regulation is being demanded by a public that has identified "light touch" regulation as a key reason for the financial crisis. The result is a greatly increased regulatory burden that is unlikely to be lightened any time soon.

International Accounting Standards Board (IASB)

Increased international trade, coupled with the growing impact of globalization, resulted in pressure from various sources for a greater harmonisation of international accounting practice. This led in 1973 to the formation of the International Accounting Standards Committee (IASC), renamed some years later as IASB. By 1999 IASB had representatives from accounting bodies in almost 100 countries, as well as other organizations with an interest in the financial reporting process.

The appointment of David Tweeedie to lead IASB marked a key turning point. Under his leadership it developed into a very influential body with an emphasis on a "principles-based" approach, as distinct from the "rules-based" approach, favoured by FASB.

In 1995 the IASC signed an agreement with the International Organization of Securities Commissions (IOSCO) to develop a set of new standards which, with the agreement of IOSCO, would form an acceptable basis for reporting