7. Accounting and auditing: Openness for business

This chapter gives a general summary of UK accounting and auditing requirements, and also deals with some frequently asked questions (FAQs).

7.1 Overview

It is considered best practice for a new business to keep detailed records of all the transactions it enters into. For a company, this is a legal requirement, and, with the exception of certain unlimited companies, some form of public filing of this information is required.

For any company other than the very smallest, this information is required in a standard form, as set out in the Companies Act 1985 ('the Act'), and these accounts must be audited.

An audit is carried out by firms of Chartered Accountants, who are authorised to carry out such work. Their aim is to provide an opinion on the “truth and fairness” of the accounts, and also an opinion on whether they comply with the Act.

7.2 Reporting requirements

The format and content of a company’s annual financial statements (often called annual accounts in the UK) are governed both by the Companies Act 1985 and by either International Financial Reporting Standards (‘IFRS’) or UK Financial Reporting Standards (FRS) (formerly called Statements of Standard Accounting Practice – SSAPs). A company can choose whether to adopt IFRS or UK FRS (unless it is listed, in which case IFRS are mandatory).

UK accounting standards are broadly consistent with international accounting standards, although there are some differences. The Stock Exchange has had only an indirect influence on accounting practices, its main interest being the extent of the information to be disclosed. Tax law has not affected accounting principles or financial statement presentation in the way that it has in some other countries.

Financial statements must be submitted to the shareholders in a general meeting and filed with the Companies Registry within, typically, ten months following the end of the company’s financial year; companies with interests abroad are allowed a further three months on application.

The Act permits two alternative balance sheet formats, vertical and horizontal, both of which must provide the same information. Four profit and loss account (income statement) formats are allowed; formats 1 and 3 show expenses by function, and formats 2 and 4 by type of expenditure. Formats 1 and 2 are vertical, and formats 3 and 4 horizontal. Most balance sheets and profit and loss accounts are prepared in vertical format.

Much of the detail that is required can be relegated to notes accompanying the financial statements, but certain specified items must be shown on the face of the balance sheet or profit and loss account, as appropriate.

Major classifications of a company's business, such as activities in different industry sectors or geographic areas, must normally be distinguished to show their contributions to turnover and profitability. Specified transactions with related parties must be disclosed. A cash flow statement is required showing the company's inflows and outflows of cash.

Financial statements must be accompanied by a directors' report commenting on the company's activities, its results, and likely future developments, as well as giving additional details required by the Act, such as a discussion of the risks the company faces in carrying on its activities.

The accounting policies adopted must be described in the notes to the financial statements; these policies should comply with IFRS/UK FRS. In the unlikely event of significant departures being made from applicable standards, these must be disclosed and explained and their effects quantified. The effects of any change in the basis of accounting must also be disclosed in the financial statements and notes.

Specialised enterprises such as insurance companies, banks, and other financial institutions are subject to particular requirements. Small or medium-sized companies are allowed to omit some detail in the financial statements they are required to file with the Companies Registry. Financial statements can be prepared in currencies other than pounds sterling if this is appropriate.

If a company has subsidiaries, group financial statements, in the form of consolidated accounts, must be prepared, unless:

(i) the company is itself a parent company of a group that is defined by the Act as a small or medium-sized group. This exemption, however, is subject to a number of conditions; or

(ii) the company is itself a subsidiary of an immediate parent established under the law of an EU member state; and

  (a) the company is a wholly owned subsidiary of that parent; or

  (b) that parent holds more than 50% of the company's shares and the minority shareholders have not requested the preparation of group financial statements.

The main difference between the accounting practices of a public listed company and a private company is the extent of the disclosure required to be given by a listed company, particularly of the disclosure of its Corporate Governance and Directors' Remuneration. Such disclosure is governed by Stock Exchange rules, as well as the Companies Act.

7.3 Accounting principles and standards

The fundamental Companies Act requirement in the UK is that every company's financial statements must give a true and fair view of its financial position and must comply with the provisions of the Act. There are no detailed guidelines as to what constitutes a true and fair view, and commercial and professional judgement has to be applied within the bounds of the Companies Act and IFRS/UK FRS and SSAPs. Financial statements must be prepared on a consistent basis and with prudence, on the assumption that the company's business can continue as a going concern (unless it is inappropriate to make this assumption). Assets and liabilities must not be offset against each other, and the accruals basis must be used.

The financial statements sent to the tax authorities are the same as those prepared for the shareholders or other proprietors, but they have attached to them a reconciliation of the published profit with the profit assessable for tax purposes.

7.4 Audit requirements and standards

Typically, at the first meeting of the Board of Directors, a firm of auditors will be appointed. The auditors actually report to the shareholders of the company, and, therefore, this appointment will require re-confirmation for each subsequent year by the shareholders at the Annual General Meeting (unless they have waived the right to do so).

The auditor's role is prescribed, by statute, as being to give an opinion on:

- the truth and fairness of the financial statements;
- whether the financial statements comply with the Companies Act;
- whether the Directors' Report is consistent with the accounts;

In addition, the auditors are also obliged to report to the shareholders if, in their opinion:

- proper accounting records have not been kept by the company (including branches);
- the financial statements do not agree to the accounting records;
- they have failed to obtain all the information they believe is necessary to do their work.

Audit procedures are established by firms individually, following guidance from the Accounting Bodies and Company Law, supported by Auditing Standards. Auditors commonly devise tests to assess the integrity of a company's system of internal control before making further tests upon the financial statements under review. Statistical sampling, circularisation, the use of computer test packs and physical inspection are just some of the procedures commonly used.

How can Deloitte help?
Deloitte is a pre-eminent firm of chartered accountants, who can assist in this area in a number of ways, including:

- acting as auditors;
- advising on accounting procedures;
- assisting with selection of accounting software;
- ensuring the financial statements comply with relevant legal and accounting regulation.

7.5 Frequently asked questions

What type of organisations must be audited?
Any organisations can be audited if the shareholders or owners so desire, but there is a legal requirement at present for the financial statements of limited liability companies and unlimited companies to be audited. This legislation is prescribed within the Companies Act. However, for most companies with a turnover below £5,600,000 there is no requirement for an audit.

A UK branch of a company incorporated outside Great Britain, has no UK audit requirement but is required to deliver to the Registrar of Companies, a copy of all the published accounting documents of its parent company, which are disclosed in accordance with the law where its parent company is located.

For tax purposes, HM Revenue and Customs usually relies on the professional integrity of the company's auditors, who often also act in the capacity of tax advisers. Wide powers are, however, given to HM Revenue and Customs to seek information on which to base its taxation assessments.

How is the audit fee calculated?
Audit fees are based on time spent at rates which reflect the expertise of the professionals involved. The charge rate per hour is set by each professional firm which then seeks to recover this from its client.

The time taken to conduct an audit is both a reflection of the standard of the company's systems of internal control and accounting efficiency as well as its size. The auditors should not, in general, be expected to generate the information on which they are to express their opinion. It is this dual role which frequently leads to misunderstanding, therefore the terms of the engagement should always be agreed in advance.

What sort of audit procedures are used? What is the timing and how should the company prepare for the audit?

The company should always decide on its own timetable for the production of audited financial statements, although there are time limits prescribed by the Companies Act. The practicality of the timetable can be determined by discussion between the company and the auditor in order to produce a cost-effective and efficient product. Information that the auditor needs in order to express his opinion has to be produced by the company and the timetable should allow for this. The accounting policies and procedures necessary to implement them need to be agreed at an early stage and all problems should be addressed by an executive with the appropriate level of authority within each organisation.

What is the time schedule of the first year for appointment of auditors, audit, directors' meeting, Annual General Meeting and filing of financial statements?

The first meeting of the Board of Directors of the company should be held as soon as possible after incorporation and should seek to determine the following:

- changes of director and secretary;
- transfer of subscriber shares;
- allotment of further shares;
- appointment of auditors;
- appointment of bankers and the authority to run bank accounts;
- appointment of a managing director and chairman (optional);
- change of registered office, if needed;
- issue of share certificates.

Within nine months from incorporation, the company must select an accounting reference date and file written notification (Form 224). The first financial statements must be for a period of not less than six months and not more than 18 months from the date of incorporation to the accounting reference date.

The first Annual General Meeting (AGM), at which the directors must produce copies of the annual accounts together with the auditors' report and directors' report, should be held within 18 months of incorporation. Members of a private company may, however, elect not to produce the accounts and reports at that meeting. Where this election is made, every member must be sent a copy of the accounts and reports not less than 28 days before the end of the 10 months after the last day of the relevant accounting reference period, together with a notice informing the member of his right to require the production of accounts and reports before a general meeting.

An Annual Return has to be filed within 12 months of the date of incorporation and thereafter annually on the anniversary of incorporation. This filing date can be moved to the end of the relevant month.

Financial statements must be filed for private companies within 10 months of the accounting reference date.

If the company reports to one of the regulatory bodies, it may be required to submit audited financial statements together with other information, usually within three months of the accounting reference date.

Must all the company's financial statements be filed?

The set of financial statements to be filed must normally include:

- directors' report;
- statement of directors' responsibilities;
- balance sheet;
- profit and loss account;
- notes to the financial statements;
- cash flow statement;
- notes to the cash flow statement.

The balance sheet must be signed by a director to confirm the approval of the financial statements by the board.

The Companies Act does allow companies which are defined as 'small' or 'medium-sized' to file modified financial statements which are different from those produced for shareholders. The qualifying conditions for this are that a company in a year does not exceed two or more of the following criteria:

	Small	Medium-sized
Turnover	£5,600,000	£22,800,000
Total assets	£2,800,000	£11,400,000
Average number of employees	50	250

Small companies need not file profit and loss accounts or directors' reports and are permitted to condense their balance sheets and supporting notes. Medium-sized companies need not file details of turnover, cost of sales or other operating income, or analyse turnover, cost of sales or other operating income, or analyse turnover and profits by activity and geographical area.

Every company must send copies of its annual financial statements to all its shareholders.

What are the bases upon which the company's financial statements are drawn up?

The Companies Act establishes the format for reporting financial information. The Act enshrines the concept of accruals, consistency, prudence, going concern and the separate evaluation of individual items but with the overriding requirement that they show a true and fair view.

Every company is required to maintain proper books and records to safeguard the assets and reflect accurately the liabilities, as well as to record income and expenditure. Such records should disclose with reasonable accuracy, at any time, the financial position of the company at that time.

The directors of the company are responsible for the financial statements and remain so, even if they have employed a third party to prepare or assist in the preparation of the financial statements.

Companies are also expected to comply with IFRS or UK SSAPs and FRS as appropriate, which are issued by the professional accounting bodies from time to time. This can be a complex area and professional advice should be sought in conditions of uncertainty.

Are there major differences between generally accepted accounting principles in the UK and other countries?

The answer in brief must be yes. There is a requirement for group consolidations. Accounting for exchange translation and deferred taxation are certainly areas of difference. It is acceptable in the UK to revalue certain assets wholly or in part.

Accounting Standards around the world are not the same and early discussion with financial advisers is urged so that the specific differences of any particular company can be highlighted and discussed.

Can the audit firm I choose help me set up an accounting system, give me tax and management consulting advice, and generally guide me on my business matters?

Yes, it can assist in these ways, provided that professional independence is maintained. At first, a foreign company may need technical assistance or more general advice. Deloitte can offer specific assistance on the establishment of the accounting and reporting systems, advice on computer systems, training assistance and temporary loan of staff. A company should, of course, seek to increase in size sufficiently to run these systems on its own, as quickly as possible.