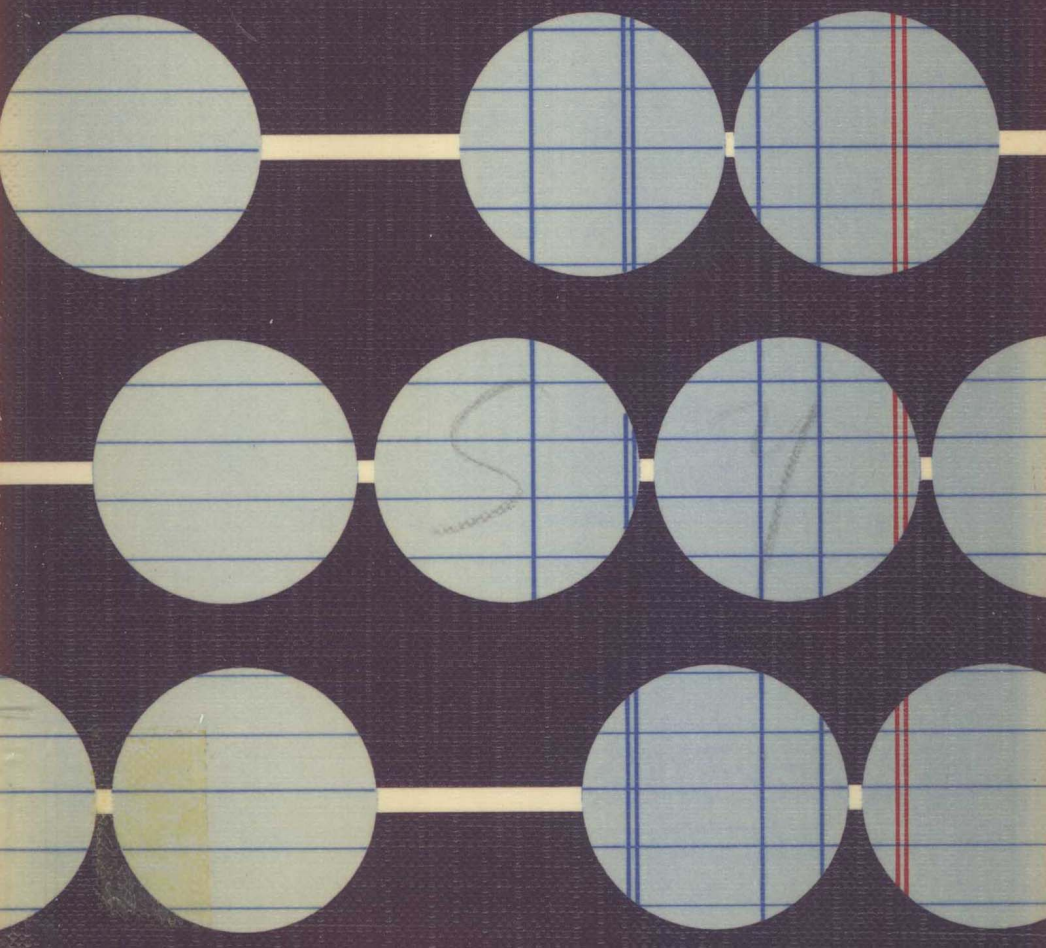
Peter Bird

Understanding Company Accounts



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Peter Bird
April 1978

Contents

1 Introduction

1.1 Aims

A person with no previous technical knowledge of accounting should be able, after studying this volume, to pick up a set of published accounts and get out of them a high proportion of the information that it is possible to derive from them. And—what is probably of at least equal importance—he should also be able to avoid reading into the accounts items of information which are not in fact there, though they may appear to the untutored eye to be there.

1.2 Accounts as coded messages

There is very real danger that casual readers of accounts will find in them meanings that are not in fact intended or true, because accounts are a form of coded message. We tend to think of codes as devices used by senders of messages so as to prevent their enemies from understanding the messages. But in fact codes are also used by all sorts of specialists as a convenient jargon to give to messages passed between members of the specialist 'club' a brevity and a precision of meaning which general-use language lacks. Such codes exclude outsiders from the meaning of the messages just as effectively as if they were enemies. In the opinion of Professor L. C. B. Gower, 'to the average investor or creditor—"the man on the Clapham omnibus"—[company accounts] are cryptograms which he is incapable of solving' (*The Principles of Modern Company Law*, Stevens). But the big difference is that the 'code books' are available to all who are willing to take the trouble to study them. This volume is a sort of elementary code book on company accounts.

There are three stages in the extraction of meaning from a coded message, whether it be the jargon of specialists, the military orders

of an enemy or an inscription in an unknown language. The first stage, the correct receipt of the coded message, presents problems where an ancient inscription may be fragmentary or illegible and where an enemy is trying to prevent you from hearing his radio messages even in code. However, companies have a legal duty to make their accounts publicly available and most companies will go further than the law requires by sending a copy of their accounts to anyone who asks for them. So will most other organizations in which the public has an interest; but a few refuse to disclose their accounts—including in my experience one university and more than one charity.

The second stage is the decoding proper: the replacement of the coded symbols by their equivalents in a generally understood language. Most of our attention will need to be given to this stage. But we should not forget the third stage which is to build from the decoded message (and any other available information including earlier decoded messages) an overall picture of the situation. An enemy will, of course, be trying to make it difficult for you to do this; the creator of an ancient inscription is neutral, as he never thought of anyone decoding his work as a major clue to his culture; but the preparer of a set of accounts should be trying to assist the reader to obtain a fair overall impression of the state of affairs from the selection of items disclosed in the accounts.

These three stages have been described in the military context as the signals function, the cryptographic function and the intelligence function. (Peter Calvocoressi 'The Ultra Secrets of Station X,' *The Sunday Times,* 24 November 1974). Those on the receiving end who go through the three stages of reconstructing a picture of the situation are attempting to reverse the three-stage work of the sender of the message. The latter chooses what to report (the selection function), then encodes the message (the semantic function), then transmits the coded message (the signals function). Only at the level of the signals is there direct contact between sender and receiver.

1.3 Accounts as models

The human mind is able to cope with only a limited amount of information about a situation. Of course such ability varies among

individuals, though the variation seems to relate more to what we get out of the information provided than to the level of information provision at which we perform our individual best as information processors.

The companies and other bodies whose affairs are the subject of published accounts are nearly all very complex organizations. Their whole story for a year—even if anyone understood it all so as to be able to tell it—would completely overwhelm the capacity of the human mind to assimilate it and would take so long to tell that it would be useless ancient history by the time it was finished.

The use of specialist jargon and conventional ways of presenting information help to speed up the process and to expand the amount of information which the mind can take in. But this still leaves the preparer of accounts faced with major decisions about selection of information to include in or exclude from the accounts.

Accounts are thus a sort of 'model' made to help us to deal with something too complex to understand in its full reality. Mathematical models are constructed to reduce problems to a form in which computational techniques are able to solve them. Physical models are made to enable testing of physical effects to be carried out with less cost and danger than with the real thing. Even a child's model vehicle brings the real world down to his ability to handle it; and a blind person, who learns the shape and nature of objects mainly by touch, told me that she has only understood what bulldozers and excavators are like since children have handed to her their models of these vehicles.

All models are an uneasy compromise. Their first aim is to strip away much of the complexity of the real thing so as to produce something which is simple to understand, easy to work with and relatively cheap to produce and use. But, at the same time, it is the function of a good model to reflect the characteristics of the original and to behave like the original. Clearly the more features of the original are omitted in the interests of simplicity, the greater is the danger that the resulting model will fail to be an adequate reflection of the original.

This is a very real dilemma where accounts are concerned. 'Full disclosure' is a fashionable battle-cry today; but accounting problems cannot be solved by simply increasing the volume of information provided. Accountants are usually directly responsible for

preparing accounts and so for facing the selection problems involved in this task. But it is the readers of accounts who have to make do with the selected items of information presented in the accounts. It is therefore important that more non-accountants acquire sufficient knowledge of accounts to enable them to influence the principles of selection of information to be included in accounts.

1.4 Plan and significance of this volume

For many years accounts have been produced on the 'historic cost' basis. But in the last few years this basis of accounting has been under attack because of its failure to reflect changing prices in times of inflation. It has proved much easier to make this criticism than to agree upon an alternative system of accounting to replace the historic cost basis.

It is therefore necessary to introduce readers to accounts at a time when they are in the midst of a major change of basis, the outcome of which is not entirely clear at this time. This is not as bad as it seems at first sight. A lot of what is learned about the historic cost form of accounting will carry over into any basis which is likely to emerge from current deliberations; the treatment below will try to identify clearly the elements which are liable to be affected by a change of basis and those which are of continuing applicability.

Chapter 2 will present the historic cost basis of accounting which has been, and still is so far, the normal basis of company accounting. The chapter will be divided into four sections reflecting the four main factors which make company accounts what they are today—the technical framework, the rules for pricing assets, the rules for determining profit, and legal and professional regulations. It will be seen that only the middle two of these are 'threatened' by proposed reforms to account for the effects of inflation.

Chapter 3 will trace the origins and history of professional moves towards inflation accounting, up to the 'interim guidelines' which have been introduced shortly before the time of writing.

In Chapter 4 the analysis of accounts for comparative purposes will be discussed. Most of the discussion will be based on historic cost accounts; but the ratios considered there are equally applicable to other bases of accounting—though these would produce different numbers of course.

Learning in general terms about the way accounts are prepared needs to be supplemented by applying this knowledge to a specific set of accounts. To facilitate this, the accounts of Martonair International Limited (manufacturers of pneumatic control equipment) for the year ended 31 July 1977 are reproduced (by kind permission of the company) in the Appendix at the end of this volume, and will be referred to frequently, especially in Chapters 2 and 4. It must be emphasized that, although all the accounts are reproduced here, the pages shown represent only part of the company's annual report; this means that other, non-accounting information not reproduced here is publicly available about this company. The original page numbers in the company's annual report have been retained in the Appendix to this volume; page number references in the text which are enclosed in square brackets, e.g. '[p.9]', refer to page numbers in the Appendix.

The discussion and illustration in this volume are primarily concerned with the published accounts of companies. Even if you are particularly interested in the accounts of other types of organization this is probably the best place to start. So much more attention has been given to company accounts that they are by far the most developed and regulated forms of accounts. Most other organizations produce accounts in forms which are minimal and rather crude adaptations of company accounts to the different circumstances of their operations. Company accounting has had more influence on other organizations than is good for the accounting standards of the latter. In Chapter 5 there will be a brief look at the differences between company accounts and those of some other types of organization.

2 Company Accounts on the Historic Cost Basis

The accounts of Martonair International Limited which are reproduced in the Appendix at the end of this book are a good representative example of modern company accounts prepared on the traditional historic cost basis. This chapter will consider the four main factors which make most company accounts today similar in form and content to this particular example.

2.1 The technical framework

For many years the published accounts of companies have consisted of a balance sheet and a profit and loss account. In the last few years it has become normal practice in the United Kingdom to include also a funds statement, which has been a regular component of company accounts in the United States from a much earlier date. Each of these three statements will now be considered in turn.

Nearly all listed companies own all or a majority of the shares of other companies which are known as 'subsidiaries'. When a company with subsidiaries publishes its accounts, they are 'group accounts' usually consisting of consolidated statements of the affairs of the company and its subsidiaries treated as far as possible as if they were one company. A company with subsidiaries is also required by law to publish a balance sheet for the company alone, mainly for the information of creditors of that company, who can look only to the assets of that company for settlement of their bills. Martonair International Limited is a 'holding' company, i.e. it has subsidiaries, a list of which appears in its accounts [p.20]. It publishes therefore a balance sheet for the company alone [p.11], in which its investments in subsidiaries are the principal asset; but attention will be directed almost entirely in this section to the group balance sheet of the company together with its subsidiaries [p.10].

(a) The balance sheet

The aura of mystique which, though somewhat faded, still tends to surround accountants can be attributed in no small degree to their ability to produce balance sheets which balance. A balance sheet consists of two lists of money amounts with descriptions; it 'balances' in that when each list is added up, it produces the same total. On Martonair's group balance sheet the lists are set one under the other on the same page [p.10]; each list of 1976 figures totals £11,885,839, and each 1977 list adds to £15,187,880. Until recent years it was customary to set the two lists side by side on the opposite pages of a double-page spread. But the vertical presentation, as used by Martonair, is now adopted by nearly all companies; this is now possible because a lot of the detailed information which used to appear on the face of the accounts is now set out in supporting notes [pp.12–15]—which makes the accounts themselves much easier to read.

Despite the risk of damaging the accountant's image of technical virtuosity, it has to be admitted that it is really not very clever to get a balance sheet to balance. It is merely a reflection of the fact that in every organization there is a residual interest which claims whatever is left over and is liable for any deficiency (though such liability may be limited). In the case of a company the ordinary shareholders have the residual interest; and some individual or group must hold this position in every organization whatever the institutional arrangements or political philosophy which underlies it.

One list on a balance sheet (usually the top one in a vertical form of layout) sets out the items of value owned by the organization. Some of these will be physical items such as property, machines and stock-in-trade; others will be 'intangible' claims such as amounts receivable from debtors for unpaid credit sales and from borrowers of loans from the company and balances held by the company's bankers. The items in this list are known as 'assets'.

The other list consists of claims to those assets. These claims are of two sorts. First, there are the 'liabilities' to meet the claims of others to fixed money amounts; these are the 'other end' of intangible claims like the ones the company holds as assets, and consist of unpaid bills payable to trade creditors and amounts due, immediately or at a later date, to lenders and to tax authorities. All these liabilities can be fully settled by payment of known fixed

amounts of money (occasionally the amount of a liability is not yet known, and the words 'provision for . . . .' are inserted before the item in the accounts to indicate this).

The other sort of claim is that of the residual interest, which consists of whatever is left over. Its amount is thus defined as assets *less* liabilities. And so it is not surprising that the total of a list of assets is equal to the total of liabilities *plus* residual interest. Only arithmetical error could prevent this result from arising! It can be seen that the term 'shareholder' is most appropriate for the holder of a share in the residual interest; his shares may be called 'ordinary shares of 20p each' as in the case of Martonair [p.14, Note 11], but their value at any time is related not to this 20p label but to the residual interest in the company and the number of other shares with which it has to be shared.

The assets on a balance sheet are divided into two main categories, based on the intention for which they are held. Fixed assets are those which have been acquired for use in the business, while current assets are cash and other items which will be converted into cash in the ordinary course of business, notably stock-in-trade and debtors. Note that the distinction does not depend at all on the physical nature of the assets; a van is a fixed asset of a company which uses it to deliver the goods which it sells, but a current asset in the hands of a motor dealer (though even a motor dealer does own some motor vehicles as fixed assets for use within the business). Investments which are held as a way of using temporarily surplus cash pending its use within the business are current assets. Investments which are held long-term will be regarded here as fixed assets; but the latter term is often, as on the Martonair balance sheet [p.10], confined to the operating fixed assets of the business while long-term investments are treated as a separate main heading.

Liabilities are also divided into two sub-groups based on the time at which it is expected that payment will have to be made. If settlement will be made within one year of the balance sheet date, they are current liabilities; if not, they are long-term liabilities. In general, this means that trade creditors are current liabilities and loans are long-term liabilities; but this is not the classification criterion and occasionally it does not work out like this—in particular long term loans do eventually reach the last year of their term

and should then be classed as current liabilities.

Our first equation:

$$\text{Assets} = \text{liabilities} + \text{residual interest}$$
$$A = L + R$$

is now expanded to

Fixed assets + current assets = current liabilities + long-term liabilities + residual interest.

$$FA + CA = CL + LL + R$$

All balance sheets consist of some further expansion, and maybe rearrangement, of this equation. In particular it is common to rearrange the equation so that current liabilities come next to current assets and can be deducted from them to show a sub-total of 'net current assets'. This is some indication, admittedly rather crude, of the prospect of the company having enough liquid funds to meet its short-term liabilities in the near future.

The arrangement of the equation used on the Martonair Group balance sheet [p.10], and the 1977 figures related to it, are as follows:

		£	
FA	Fixed assets (inc. investments)	5,016,730	(4,863,151
+(CA+	Current assets	18,266,504	+ 143,059 + 10,520)
−CL)	− Current liabilities	8,095,354	
	= Net current assets	10,171,150	
		15,187,880	
=	= (financed by)		
R	Residual interest	13,107,794	(12,906,008
			+ 201,786*)
+LL	+ Long-term liabilities	2,080,086	(992,306 +
		15,187,880	1,087,780)

*The amount of £201,786 'applicable to minority interests' which has been included above in the residual interest is the interests of shareholders other than Martonair International Ltd who hold some equity shares in the subsidiaries in Australia and France [p.20]. The group accounts are prepared first on the basis that the whole of all the subsidiaries belongs to the holding company; then the interests of minority shareholders are deducted as a separate item.

Most readers of accounts are primarily interested in what has been happening in the organization, and often in what is likely to happen in it in the near future. The weakness of the balance sheet is that it gives only a still picture at a single moment in time. By laying a series of annual balance sheets side by side it is possible to get a very jerky moving picture of the net effects of the events of a series of years. But readers, especially holders and potential holders of residual interest rights, want to know more than the balance sheets tell them about how the residual interest has changed between one balance sheet and the next. This is the function of the profit and loss account of a business, and of its equivalent in non-profit-seeking organizations—the income and expenditure account.

(b) The profit and loss account

There are two matters which changed the shareholders' interests in Martonair International Limited during the year to 31 July 1977, and which are not reflected in its group profit and loss account [p.8]. So the link between the profit and loss account and the balance sheet sub-total for share capital and reserves must first be clearly demonstrated. This requires reference to Notes 11 and 12 [p.14] which detail the movements on share capital and reserves during the year. With the aid of this information the following reconciliation can be made:

Share capital and reserves (captioned 'Applicable to Shareholders of Martonair International Ltd') —31 July 1977	12,906,008
31 July 1976	9,886,330
Increase during year	£3,019,678
Profit retained for year (next to last line of [p.8]; shown as two figures £936,876 and £539 in Note 12 [p.14])	937,415
Adjustment in respect of exchange (the sterling equivalent of overseas assets rose during the year, see policy note 1(C) [p. 12])	863,759
Proceeds of rights issue of 1,265,980 ordinary shares (20p per share shown under share capital [p.14, Note 11] and the balance under reserves as a 'share premium' [p. 14, Note 12])	1,218,504
	£3,019,678