Accounting

Financial Accounting Regulations, Social Accounting and Principles of Auditing

[ADVANCED HIGHER]

Susan McAuley
Acknowledgement
Learning and Teaching Scotland gratefully acknowledge this contribution to the National Qualifications support programme for Accounting.

First published 2005

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ISBN 1 84599 079 2
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Accounting Standards Board

The Financial Reporting Council (FRC) is the UK’s independent regulator for corporate reporting and governance. The chairman of the FRC is appointed by the Department of Trade and Industry and the Bank of England. The functions undertaken by the regulator are carried out by operating bodies that it supervises; these include the Accounting Standards Board and the Auditing Practices Board.

The Accounting Standards Board (ASB) took over from the Accounting Standards Committee (ASC) in 1990. Under the terms of the Companies Act 1985 its role includes developing principles to guide standards; to provide a framework to resolve financial accounting and corporate reporting issues; and to issue new accounting standards or amend existing ones. The ASB has the power to issue its own standards which the ASC did not, the intention being to increase the quality of accounting standards and increase the speed with which they are issued in response to new problems encountered in accounting. The ASC also contributes to the achievement of the FRC’s fundamental aims by improving standards of financial accounting and corporate reporting.

The ASB has up to ten board members. The Chairman and Technical Director are full-time members while the remainder, who represent a variety of interests, are part-time. Board members are appointed by a Nominations Committee comprising the chairman and fellow directors of the Financial Reporting Council (FRC). Three observers also attend ASB meetings. Under the ASB’s constitution, votes of seven board members are required for any decision to adopt, revise or withdraw an accounting standard.

The ASB also collaborates with accounting standard-setters from other countries and the International Accounting Standards Board (IASB) to guarantee that its standards are developed with due regard to international developments as well as to ensure they influence the development of international standards.

The Accounting Standards Board is autonomous in its role in issuing standards. It is, however, the practice of the Board to consult widely on all its proposals.
The accounting standards produced by the ASB are called ‘Financial Reporting Standards’ (FRSs). The former ASC standards were designated ‘Statements of Standard Accounting Practice’ (SSAPs). The ASB are gradually renewing the SSAPs with FRSs but some SSAPs still remain and they fall within the legal definition of accounting standards. ‘Accounting standards are authoritative statements of how particular types of transactions and other events should be reflected in financial statements and accordingly compliance with accounting standards will normally be necessary for financial statements to give a true and fair view’ (FRC 2004).

Accounting standards are authoritative statements detailing how particular types of transaction should be reported in financial statements and accordingly compliance with accounting standards will normally be necessary for financial statements to give a true and fair view.

Although the initial purpose of creating accounts standards was to define proper accounting practice within a legal framework, it has also resulted in the creation of a common understanding between users and preparers.

Accounting standards apply to all companies and other kinds of entities that prepare accounts which are intended to provide a true and fair view. New topics which are recognised as requiring FRSs are identified by the Board through research or submissions from interested parties. Unlike its predecessor body (the ASC), the ASB can issue accounting standards on its own authority, without the approval of any other body. The ASB also develops principles to guide it in establishing accounting standards; their statement is discussed later (page 9).

Development of Accounting Standards

The ASB identifies topics that become the subject of FRSs, either from its own research or from external sources, including submissions from interested parties.

When a topic is identified by the ASB as requiring the issue of an FRS, the ASB commissions its staff to undertake a programme of research and consultation. This programme involves consideration of and consultation on the relevant conceptual issues, existing pronouncements and practice in the United Kingdom, the Republic of Ireland and overseas, as well as the economic, legal and practical implications of the introduction of particular accounting requirements.
Once the issues have been identified and debated, the ASB produces a discussion draft which is circulated to any parties who have registered their interest. If they consider more discussion is required, a discussion paper which sets out the issues and, if appropriate, proposed solutions would be published instead. Both of these papers are designed to allow parties who will be affected by the proposal to have a say in its articulation.

Thereafter an exposure draft of an accounting standard (a Financial Reporting Exposure Draft or FRED), setting out the text of the proposed standard, is published to allow an opportunity for all interested parties to comment on the proposals and for the Board to gauge the appropriateness and level of acceptance of those proposals.

Any feedback received before a stated deadline is used to refine the exposure draft where necessary, and depending on comments received may result in another period of public exposure prior to issuing the FRS.

All the relevant information is available on the ASB’s website and interested parties can make comments on proposals by e-mail. Thereafter the comments from interested parties are discussed and a technical plan is developed. From this the final standard is developed.

From time to time and for a variety of reasons, deficiencies in accounting standards can become apparent. For this reason a sub-committee of the ASB was formed following a recommendation in the Dearing Report. This sub-committee is called the Urgent Issues Task Force (UITF) and is called upon to resolve such issues urgently, where appropriate.

**Urgent Issues Task Force**

The UITF comprises up to fifteen members experienced in the technicalities of financial reporting. Its purpose is to enlist the experience and influence of its members to assist the ASB in its task of establishing and improving standards of financial accounting and reporting, for the benefit of users, preparers and auditors of financial information.

When an urgent situation arises where unsatisfactory or conflicting interpretations of an existing accounting standard occur and an urgent response is required to ensure that a ‘true and fair view’ of financial statements is available, the UITF seeks to arrive at a consensus on the accounting procedures which should be adopted to rectify the situation.
Where the UITF reaches a consensus on an issue (which is achieved only when at least eleven members vote and no more than two dissent) they produce the consensus in the form of a UITF Abstract.

This abstract is then ratified by the ASB after ensuring that it does not conflict with the law, accounting standards or their present or future policy or plans; also ensure it has regard to international developments.

If the abstract meets the criteria laid down by the ASB, it is adopted without further consideration. The UITF Abstract is then circulated and is thereafter regarded as accepted practice in the area in question.

**International Accounting Standards Board**

The International Accounting Standards Board (IASB) was formed in April 2001 and is an independent accounting standard-setter based in London.

The International Accounting Standards Committee (IASC) had complete autonomy in setting international accounting standards and in publishing discussion documents on international accounting issues until a restructuring took place in March 2001 and the IASB assumed accounting standard-setting responsibilities.

The IASB structure has the following main features: the IASC Foundation is an independent organisation having two main bodies, the Trustees and the IASB, as well as a Standards Advisory Council and the International Financial Reporting Interpretations Committee. The IASC Foundation Trustees appoint the IASB members, exercise oversight and raise the funds needed, but the IASB has sole responsibility for setting accounting standards.
Statement of Principles

The ASB published its Statement of Principles for Financial Reporting in December 1999. Its conception is based on the recommendations of a report produced by a review committee under the Chairmanship of Sir Ron Dearing CB, published in September 1988:

‘a lack of a conceptual framework is a handicap to those involved in setting standards as well as to those applying them. ... We believe that work in this area will assist standard-setters in formulating their thinking on particular accounting issues, facilitate judgements on the sufficiency of the disclosures required to give a true and fair view, and assist preparers and auditors in interpreting accounting standards and in resolving accounting issues not dealt with by specific standards.’

The Statement was derived from the ASB’s original informal frame of reference with many of the original principles having contributed to the standard-setting process for nearly ten years. The ASB refined and expanded some of these original principles to produce the framework and intends to continue doing so on a regular basis as accounting continues to evolve.

The Statement of Principles describes the accounting model that is used by the ASB as the conceptual foundation for their work. Statements therefore typically describe the standard-setter’s views on:

• the activities that should be reported on in financial statements
• the aspects of those activities that should be highlighted
• the attributes that information needs to have if it is to be included in the financial statements
• how information should be presented in those financial statements.

The main purpose of the Statement is to provide a theoretical framework for the consistent and logical formulation of accounting standards. It also provides a framework which can be used to resolve accounting issues, the absence of which was previously one of the greatest problems faced by accountants. This framework establishes the needs and objectives of users, and this assists in ensuring the consistency of a true and fair view.

The main role of the Statement is to provide conceptual input into the ASB’s work on the development and review of accounting standards. Although the Statement itself is not an accounting standard, a number of the principles within the Statement play fundamental roles in existing
accounting standards. For example, the Statement’s views on the presentation of information about financial performance are embodied in FRS 3 ‘Reporting Financial Performance’ (see p12 of this pack).

The Statement of Principles therefore plays a very important role in the standard-setting process, although it is only one of the factors that the ASB takes into account when setting standards. Other factors include legal requirements, cost-benefit considerations, industry-specific issues, the desirability of evolutionary change, and implementation issues.

The development of this conceptual framework took into consideration the ASB’s belief that there is a need for accounting practice around the world to converge towards a set of globally accepted standards. They are of the opinion that a common set of principles should be adopted by all the standard-setters involved to ensure convergence can be achieved. Consequently they referred to framework documents from countries such as Australia, Canada, New Zealand and the USA as well as the International Accounting Standards Committee’s ‘Framework for the Preparation and Presentation of Financial Statements’ so that unification could take place as straightforwardly as possible.
Examples of Financial Reporting Standards

The Statement of Principles for Financial Reporting is, with appendices, over a hundred pages long, and it is not an easy document for those approaching it for the first time to dip into. Below are summaries of examples of FRSs.

Cash Flow Statement  
Issued: September 1991  
FRS 1 (Revised 1996)

FRS 1 (revised 1996) requires reporting entities within its scope to prepare a cash flow statement in the manner set out in the FRS. Cash flows are increases or decreases in amounts of cash, and cash is cash in hand and deposits repayable on demand at any qualifying institution less overdrafts from any qualifying institution repayable on demand.

An entity’s cash flow Statement should list its cash flows for the period classified under the following standard headings:

- Operating activities
- Returns on investments and servicing of finance
- Taxation
- Capital expenditure and financial investment
- Acquisitions and disposals
- Equity dividends paid
- Management of liquid resources
- Financing

An appendix to the standard sets out examples of cash flow Statements for an individual company, a group, a bank and an insurance group.

FRS 1 (revised 1996) replaced the original FRS 1 issued in September 1991 to replace SSAP 10 ‘Statements of source and application of funds’. At the time the requirement for a cash flow Statement instead of a Statement of source and application of funds represented a radical change in financial reporting. However, cash flow Statements had increasingly come to be recognised as a useful addition to the balance sheet and profit and loss account in their portrayal of financial position, performance and financial adaptability (in particular in indicating the relationship between profitability and cash-generating ability) and thus of the quality of the profit earned.
Reporting Financial Performance

Issued: October 1992

FRS 3

FRS 3 has changed the way in which performance is reported. Its objective is to require entities to highlight a range of important components of financial performance to aid users in understanding the performance achieved by the entity in a period and to assist them in forming a basis for their assessment of future results and cash flows.

The standard requires a layered format for the profit and loss account to highlight a number of important components of financial performance:

(a) results of continuing operations (including acquisitions);
(b) results of discontinued operations;
(c) profits and losses on the sale or termination of an operation, costs of a fundamental reorganisation or restructuring, and profits or losses on the disposal of fixed assets; and
(d) extraordinary items.

The effect of the standard has been effectively to outlaw extraordinary items. If any were to arise, the standard requires them to be included in the earnings figure used to calculate earnings per share.

The standard also requires a Statement of total recognised gains and losses to be shown. This is a primary financial Statement that includes the profit or loss for the period together with all movements in reserves reflecting recognised gains and losses attributable to shareholders.

A note of historical profits, which is a memorandum item, is also required. The purpose of this note is to present the profits or losses of entities that have revalued assets on a more comparable basis with those of entities that have not.
Goodwill and Intangible Assets

Issued: December 1997
FRS10

The objective of FRS 10 is to ensure that purchased goodwill and intangible assets are charged to the profit and loss account (income Statement) in the periods in which they are depleted.

The standard takes the view that goodwill arising on an acquisition (i.e., the cost of acquisition less the aggregate of the fair value of the purchased entity’s identifiable assets and liabilities) is neither an asset like other assets nor an immediate loss in value. Rather, it forms a bridge between the cost of an investment shown as an asset in the acquirer’s own financial Statements and the values attributed to the acquired assets and liabilities in the consolidated financial Statements. Although purchased goodwill is not in itself an asset, its inclusion amongst the assets of the reporting entity, rather than as a deduction from shareholders’ equity, recognises that goodwill is part of a larger asset, the investment, for which management remains accountable.

An intangible item may meet the definition of an asset when access to the future economic benefits that it represents is controlled by the reporting entity, whether through custody or legal protection. However, intangible assets fall into a spectrum ranging from those that can readily be identified and measured separately from goodwill to those that are essentially very similar to goodwill. The basic principles set out in the standard for accounting for intangible assets that are similar in nature to goodwill are therefore closely aligned with those set out for goodwill.

The standard requires purchased goodwill and certain intangible assets to be capitalised and, in most circumstances, to be amortised systematically through the profit and loss account (usually over 20 years or less). Impairment reviews must be undertaken, particularly if the goodwill or intangible asset is regarded as having an infinite life and is therefore not being amortised. Internally generated goodwill should not be capitalised and internally developed intangible assets should be capitalised only where they have a readily ascertainable market value.
Tangible Fixed Assets

*Issued: February 1999*

*FRS15*

FRS 15 sets out the principles of accounting for tangible fixed assets, with the exception of investment properties, which are dealt with in SSAP 19 'Accounting for investment properties'. The objective of the FRS is to ensure that tangible fixed assets are accounted for on a consistent basis.

Consistently with previous practice (as reflected, for example, in the Companies Act), the FRS permits a choice as to whether tangible fixed assets are stated at cost or at revalued amount. However, where an enterprise chooses to adopt a policy of revaluing some assets, all assets of the same class (that is, those with a similar nature, function or use) must be revalued. The FRS also contains requirements that ensure that the valuations are kept up to date.

FRS 15 incorporates many of the requirements of SSAP 12 'Accounting for depreciation' which it will supersede in due course. The FRS acknowledges that in a limited number of cases, no depreciation charge may be made on the grounds that it is immaterial. Where this is the case, or where depreciation is calculated on a basis that assumes that the useful economic life of an asset is longer than fifty years, the standard requires annual impairment reviews to be performed, to ensure that the carrying amount of the asset is not overstated.

FRS 15 is effective for accounting periods on or after 23 March and is in place as a result of following the Accounting Standards development procedure discussed previously which resulted in FRED 29 being produced and put up for discussion to interested parties. Acceptance of this proposal results in SSAP 19 now being superseded.
Accounting Policies  
*Issued: December 2000* 
*FRS 18*

FRS 18 deals primarily with the selection, application and disclosure of accounting policies. Its objective is to ensure that for all material items:

- an entity adopts the accounting policies most appropriate to its particular circumstances for the purpose of giving a true and fair view;
- the accounting policies adopted are reviewed regularly to ensure that they remain appropriate, and are changed when a new policy becomes more appropriate to the entity’s particular circumstances; and
- sufficient information is disclosed in the financial Statements to enable users to understand the accounting policies adopted and how they have been implemented.

The FRS supersedes SSAP 2 ‘Disclosure of accounting policies’, which was published in 1971. Although in many respects SSAP 2 was still broadly satisfactory, the framework within which it discussed accounting policies was out of step with modern accounting. The FRS updates that framework to make it consistent with the ASB’s Statement of Principles for Financial Reporting.

The FRS comes into force for accounting periods ending on or after 22 June 2001, except for certain requirements relating to Statements of Recommended Practice (SORPs), which come into force for accounting periods beginning on or after 24 December 2001. Earlier adoption is encouraged.

**Summary of requirements of FRS 18**

The FRS requires accounting policies to be consistent with accounting standards, Urgent Issues Task Force (UITF) Abstracts, and companies legislation. Where this constraint allows a choice, the FRS requires an entity to select whichever of those accounting policies is judged to be most appropriate to its particular circumstances for the purpose of giving a true and fair view.

An entity should judge the appropriateness of accounting policies to its particular circumstances against the objectives of:

- relevance
- reliability
• comparability
• understandability.

The constraints that an entity should take into account are the need to balance the different objectives, and the need to balance the cost of providing information with the likely benefit of such information to users of the entity's financial statements.

An entity’s accounting policies should be reviewed regularly to ensure that they remain the most appropriate to its particular circumstances. An entity should implement a new accounting policy if it is judged more appropriate to the entity’s particular circumstances than the present accounting policy.

The FRS requires specific disclosures about the accounting policies followed and changes to those policies. It also requires, in some circumstances, disclosures about the estimation techniques used in applying those policies.
Financial Accounting Regulations – Questions

1. Explain the structure of the board of the ASB.

2. How many members are required to reach consensus on decisions?

3. What are Statements of Standard Accounting Practice gradually being replaced with?

4. The International Accounting Standards Committee was formed in 1973 as a result of an agreement by accountancy bodies in several countries. Access their website at www.iasb.org and identify which countries were involved in the original committee.

5. Why was the Statement of Principles established?

6. Name two situations where someone auditing accounts may refer to the Statement of Principles.

7. Which FRS deals with extraordinary items?

8. Where would an insurance group find the appropriate layout for a cash flow statement?

9. Which FRS ensures that sufficient information is disclosed to users of financial statements?

10. How can tangible assets be valued?

11. How is the value of goodwill on a purchase calculated?
Financial Accounting Regulations – Solutions

1. The ASB has up to ten board members. The Chairman and Technical Director are full-time members while the remainder, who represent a variety of interests, are part-time. Board members are appointed by a Nominations Committee comprising the chairman and fellow directors of the Financial Reporting Council (FRC). Three observers also attend ASB meetings.

2. Under the ASB’s constitution, votes of seven board members are required for any decision to adopt, revise or withdraw an accounting standard.

3. Financial Reporting Standards

4. Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom, Ireland and the United States.

5. After recommendation in a report produced by a review committee of the ASB, which recommended that a conceptual framework would assist preparers and auditors to interpret accounting standards.

6. Any examples of situations with regard to activities reported on in financial statements; aspects of activities which should be highlighted; necessary attributes of financial information and presentation of financial information in financial statements.

7. FRS 3 Reporting Financial Performance

8. FRS 1 Cash Flow Statements

9. FRS 18 Accounting Policies

10. At cost or at revalued amount.

11. The cost of acquisition less the aggregate of the fair value of the purchased entity’s identifiable assets and liabilities.
Social Accounting

Social accounting is a way of measuring and reporting on an organisation’s social and ethical performance. The question of whether environmental and social accounting should be developed has been replaced by the questions of how and when. Whether these developments will arise through legal, market, professional or industry initiatives is not yet clear, but there is both an inexorability and an inevitable desirability about these new accounting developments. No well-managed business or self-respecting professional accountant can afford to ignore them.

The purpose of a business is not just to make a profit. To assume that profit is the only goal is to mistake the means for the end. The idea that those who provide the financial backing are the company’s rightful owners is outdated. Today, the value of a company is determined largely by its intellectual property, brands, patents, and the skills of its workforce. According to Charles Handy, a UK management guru and renowned modern commentator, ‘A good business is a community with a purpose, and a community is not something to be “owned”.’ A company should think of itself as a wealth-creating community, with members rather than employees. It seems only fair that the members of the community who contribute their intellectual assets should receive dividends as well as those who contribute their money. The company should make a contribution to society and the measure of success for an organisation should include outcomes for others as well as outcomes for its members.

Social accounting is a diverse activity and is principally concerned with offering a complementary form of accounting as an alternative to the dominant economic and profit-orientated emphasis of companies; it has been driven since the early 1970s by a desire to emphasise organisations’ accountability in wider terms than economic activities. Organisations have many stakeholders who it is suggested have a responsibility to be interested in the activities undertaken by a company beyond their financial pursuits, namely social and environmental activities.
Historically, social accounting was concerned with the local community, employees, consumers and environmental issues. Nowadays, awareness is raised regarding issues such as fair trade, trade with repressive regimes and transfers of wealth between developing and developed countries. Nowadays, most major organisations will include in their annual reports social information about their policies on working practices such as equal opportunities; and they will report on projects undertaken in the community or world-wide on social or environmental issues to display their intention to strengthen their social responsibility.

Social accounting extends to matters such as pollution and environmental issues, as one might expect; and it includes many other issues as well, for example:

- unsafe products and work places
- cost padding and fraud in defence contracting
- corporate bullying of communities
- racism
- equal opportunity for and the exploitation of women and other groups
- economy in operations
- the results of public-sector activities as reflected in accomplishment, benefits and effectiveness.

**Environmental issues**

We are all part of the natural environment and depend upon it for our existence and our social, economic and financial systems are directly responsible for the environmental problems we are facing today. These systems are significantly influenced by accounting procedures.

Raising awareness of environmental factors can allow companies to:

- recognise the hidden costs of waste, leading to considerable savings in raw materials use, labour costs, employee protection, training, energy use and insurance costs
- evaluate potential social impacts as a part of business decision-making
- identify and address process inefficiencies more easily, resulting in ripple-effect savings.
The twentieth century saw a vast increase in business activity with gigantic technological changes that occurred alongside the downward spiral in the health of the natural environment upon which we all depend. Many countries enjoy a very materialistic lifestyle whilst others face poverty and starvation.

There are two reasons why accounting should pay attention to environmental issues. Firstly, business and accounting are inextricably linked and since business has to respond to environmental issues, so too accounting must move with it in the same direction. Moreover, the accounting concepts of profit, cost, success and failure are fundamental issues in the environmental crisis; and without ‘greener accounting’ many environmental issues will not be implemented.

Environmental accounting is a relatively new concept which needs to be encouraged to become more widely taken up. As yet accounting standards or professional accounting examinations have not changed sufficiently to be encouraging and many businesses still have not reacted wholeheartedly to an environmental agenda that has – so far – put little pressure on accountants to adopt environmentally-responsible accounting techniques.

**Sustainability**

Sustainability is closely concerned with environmental issues. The Brundtland Report (1987) suggested that sustainable development is development activity ‘which meets the needs of the present without compromising the ability of future generations to meet their own needs’. Sustainability will almost certainly prove to be the most important policy issue with which governments, business entities and society will have to grapple in the near future as its two elements, eco-efficiency and eco-justice, grow in prominence in the world today. (Although interestingly enough, centuries ago this ethos was the one by which the Red Indians lived and died.)

Sustainability therefore relates to both present and future needs that are both social and environmental. These needs are commonly referred to as eco-justice and eco-efficiency.
Legal requirements

There are no current legal requirements that companies should report on the extent to which their activities are in harmony with the demands of sustainable development. Current environmental reporting and management practices have only the most tenuous connection with sustainability. Current guidelines which appear to deal with the issues – notably the International Chamber of Commerce’s Charter for Sustainable Development and the pronouncements from the World Business Council for Sustainable Development – fail to address the deeper questions about total resource use, let alone consider eco-justice issues.

However, UK governments report periodically on progress towards attempts to incorporate the requirements of sustainability into the economic life of the nation. This, in turn, is bound to influence the corporate environment in due course.

Furthermore, the European Union and the United Nations have explicitly addressed the role that accounting will have to play if corporations are to rise to the sustainability challenge and the United Nations Conference on Trade and Development has instigated a range of research projects intended to explore how accounting might contribute to moves in the direction of sustainability.
Social Accounting – Questions

1. Explain the meaning of social accounting.

2. Why should accounting pay attention to environmental issues?

3. Name a legal requirement pertaining to environmental accounting.

4. Use textbooks or the Internet to ascertain the definitions of the terms *eco-justice* and *eco-efficiency*.

5. Traidcraft is one of the pioneers of social accounting in the UK, having published its first independently audited report in 1993. Using the world wide web access the social accounts of this fair-trade company (http://www.traidcraft.co.uk/socialaccounts/).
   (a) Suggest two examples from this website of eco-justice.
   (b) Identify two examples of eco-efficiency.

6. Explain why you think Traidcraft is a pioneer of social accounting.
Social Accounting – Solutions

1. Answer should relate to core notes.

2. Business and accounting are linked, and business must respond to environmental issues. Accounting must move along with it. Accounting concepts of profit, cost, success and failure are fundamental issues in the environmental crisis and 'greener accounting' will assist in environmental issues being addressed.

3. There are no legal requirements.

4. *Eco-justice* asserts that it is not possible to care for the earth without also caring for humanity, and that seeking human justice must involve care for the environment. *Eco-efficiency* puts forward the notion that material and energy inputs should be reduced.

5. (a) Eco-justice
   - encourages best practice in employment policies
   - endeavours to have a direct impact on poverty
   - influences others to trade/work/legislate to the advantage of the poor.

(b) Eco-efficiency
   - Being sustainable in all they do
   - *Air travel*: To have an increase in the WEIGHT of goods carried by air that is no greater than the increase in third-world purchases.
   - *Packaging*: To have an increase in the net amount of packaging waste (after allowing for recycling) that is no greater than the increase in turnover.

6. Traidcraft’s ethos is based on eco-justice and eco-efficiency principles. These are:
   - To highlight their commitment to their working strategies and to develop appropriate indicators of impact for their stakeholders.
   - To evaluate the success of their policies in terms of increasing their direct impact; increasing their influence on others and enhancing sustainability in a recognisable and measurable way.
Principles of Auditing

‘An audit is the independent examination of, and expression of opinion on, the financial statements of an enterprise by an appointed auditor in pursuance of that appointment and in compliance with any relevant statutory obligation’ (Auditing Practices Board). The Auditing Practices Board (APB) was established in April 2002, and replaces a previous APB which had been in place since 1991.

The APB is committed to leading the development of auditing practice in the United Kingdom and the Republic of Ireland so as to:

• establish high standards of auditing
• meet the developing needs of users of financial information
• ensure public confidence in the auditing process.

Auditing was established to ensure that the final record provided on financial recordings was an accurate view of what had actually transpired between parties, and legislation was enacted to protect the rights of interested parties. An audit should ensure that the information produced by managers is not misleading.

The distinction between the work of an accountant, who prepares the accounting and financial information, and an auditor, who issues a report after examining the financial evidence supplied, must be maintained even though in practice the two jobs may overlap. It is essential that the auditor should be able to undertake his work from an independent point of view, being free to exercise judgement and apply professional ethics as, unlike some countries, an auditor in the UK is not subject to any outside vetting process.

UK company law is virtually unique in that it requires all limited companies to have their accounts audited. Companies with a turnover of less than £90,000 are exempt from compulsory audit and those with a turnover between £90,000 and £350,000 only require an independent accountant’s report.
External Auditing of a plc

Auditor’s responsibility

In the case of a public limited company (plc), a large company could require the efforts of a large team of accountants for an entire year to produce their final accounts. The ownership of the plc belongs to the shareholders, but control is normally delegated to a small number of directors, since it would be impossible to run a company where every shareholder was directly involved in management.

The directors will find themselves in situations where decisions have to be made with immense implications for the all stakeholders in the company. It has been suggested that the design of limited companies in terms of a board of directors having total discretion over the strategies implemented within a business leaves the way open for corrupt managers to profit from the investment of arms’-length and geographically widespread shareholders. This corruption can be in the form of excessive remuneration packages or substantial salaries. Stakeholders such as creditors can also be affected, as limited liability ensures shareholders and directors have no direct responsibility for amounts owed. This can result in high-risk gambles being made in situations where a company’s future is threatened. If these gambles pay off, no-one is a loser, but if not, creditors could lose out as assets which could have been used to settle debts have been misspent as a result of the gamble.

There are, of course, procedures which can be followed by shareholders to attempt to ensure that directors are working in their best interests. Shareholders have the right to receive regular reports on performance and the overall financial position of the company. However, as the directors will be involved in the preparation of these reports there is still the possibility of manipulation from that quarter.

The purpose of an audit therefore is not to provide any additional information but to allow users more confidence about the quality and integrity of the information available.

However, it is important to bear in mind that the auditor’s opinion helps establish the credibility of the financial statements. The user, however, should not assume that the auditor’s opinion is an assurance as to the future viability of the entity nor an opinion as to the efficiency or effectiveness with which management has conducted the affairs of the entity.
But it is fundamentally important that stakeholders can be confident in an audit report prepared by an independent source. This adds credibility to financial statements, which without an audit report might be worthless.

The value of an external audit for stakeholders is therefore the credibility it gives to the financial information provided by the board of directors. This credibility can be ensured by the three forms of control which an audit should provide:

- **Preventive control** – if employees involved in the processing of accounting data are aware that their work will be scrutinised, it is probable that extra care will be taken in the preparation of the financial information.

- **Detective control** – it is still possible, however, that errors may be made in the preparation of the financial statements. Auditing may uncover any errors and allow them to be corrected prior to publication.

- **Reporting control** – if errors are uncovered by the auditor which the directors are not willing to correct, the auditor can make stakeholders aware of the circumstances by referring to the situation within the audit report. This alerts stakeholders to the possibility that the information is not reliable.

**Statutory duties**

An auditor's primary duties are:

*To give a true and fair view of the company's state of affairs and its profit or loss for the financial year*

and

*To ensure financial statements have been properly prepared in accordance with the Companies Act 1985.*

Auditors have statutory rights to assist them in the performance of their duties. They have a right of access, at all times, to a company’s accounting records and other documents, and the right to require directors and employees of the company to provide information and explanations which they consider necessary. They are also entitled to attend any general meetings and speak on matters concerning them.
The following diagram illustrates an auditor’s relationships within a plc:

- **Board of Directors**
  - Prepare financial statements
  - Working relationship with Company

- **Company**
  - Provide audited financial statements
  - Contract with Auditor

- **Auditor**
  - Examine and report on financial statements

- **Shareholders**
  - Receive financial statements
  - Report on financial statements
The Audit Report

An audit report should be clear, unambiguous and presented in terms that are easily understood by all interested parties. It should be laid out in the standard format covering seven main elements:

• **The title**
  This should identify for whom the report has been produced. Although the report is produced for all stakeholders, there may be a bias towards particular interested parties, for example, if the needs of shareholders are the primary consideration this should be stated in the title as the truth and fairness of the financial statements have been considered from their viewpoints. Alternatively, the audit may be carried out by creditors where greater emphasis would be placed on valuation of assets for security purposes; again, readers would have to be aware of this bias.

• **Identification of Financial Statement audited**
  An itemisation of each financial statement examined.

• **Outline of respective responsibilities of the directors and the auditors**
  This simply states the legal positions of both parties in order to ensure that readers are aware of each party’s involvement in the accounting process.

• **Basis of auditor’s opinion**
  This informs readers of the auditor’s legal duties in terms of the Companies Act 1985.

• **The auditor’s opinion**
  This should be an explicit statement as to the auditor’s opinion on the truth and fairness of the financial statements, stating whether they give a true and fair view of the financial position of the company and whether they have been prepared in accordance with the Companies Act 1985.

• **The auditor’s signature**
  The report must be signed by the auditor to provide evidence that they accept responsibility for the report.

• **Date of report**
  The date is required to identify up to which date the auditor has had an active duty of examining the financial statements.
Principles of Auditing – Questions

1. Why might it be considered unnecessary to audit the financial records of a small company?

2. Can you suggest a reason why a small company may choose to carry out an audit on a voluntary basis?

3. How could a board of directors influence an auditor’s report?

4. How would you interpret the phrase ‘to give a true and fair view’ as part of an auditor’s primary duty.

5. The following situations have been identified within a large plc:

   An auditor has been asked to help prepare a financial information report by the directors of a manufacturing operation who are the majority shareholders and wish to sell their controlling interest in the company. The auditor has been offered a percentage of the amount raised by the sale as payment. What would you advise the auditor to do?

6. Access the Co-operative Insurance Services Financial Report for 2003 found at http://www.cis.co.uk/financial2003/. Open the Auditor’s Report and answer the following questions:

   (a) Which stakeholder group has the report been prepared for?
   (b) Which financial statements have been audited?
   (c) What is the auditor’s opinion of the financial Statements of the CIS?

7. Access Traidcraft’s Social Accounts (http://www.traidcraft.co.uk/socialaccounts/).

   (a) As there are no concise legal requirements for auditing social accounts, which standard do Traidcraft use?
   (b) The auditor’s report refers to the methodology adopted by Traidcraft to prepare their social accounts. Identify four methods used.
Principles of Auditing – Solutions

1. Often owners of small companies are involved in its management. They therefore do not require to have their own interests protected.

2. A small company may arrange an audit to provide a useful source of credible information about the company.

3. They could influence the report by putting undue pressure on the auditor with regards to levels of fees to be paid or renewal of the auditor's contract.

4. Financial Statements must portray the financial affairs of the company in such a way that anyone reading the statements can gain an impression of the financial position and performance of the company – similar to the one they would have obtained had they personally monitored the recording of the transactions.

5. The auditor should be advised not to proceed with the contract on these terms of payment as he could allow himself to be influenced in such a way as not to 'give a fair and true' view of the situation. He should either decline the offer or agree a fee for the work beforehand.

6. (a) The Members of the Co-operative Insurance Society Limited
(b) Profit & Loss Account; Balance Sheet; Cash Flow Statement
(c) In our opinion, the financial statements give a true and fair view of the state of affairs of the Society and the group as at 31 December 2003 and of the profit of the group for the year then ended and have been properly prepared in accordance with the Insurance Accounts Directive.

7. (a) Institute for Social and Ethical AccountAbility AA1000 standard
(b) • Define social objectives and ethical values of the organisation
• Be clear about who are the stakeholders of the organisation
• Establish indicators by which performance against the objectives and values can be measured
• Measure performance against the indicators
• Gain the views of stakeholders about how they view the performance of the organisation
• Report all of the above in as balanced a manner as possible
• Submit the report to independent audit
• Publish the report
• Gain feedback from stakeholders on the report’s findings.