Tenth Edition

INTERPRETING COMPANY REPORTS AND ACCOUNTS

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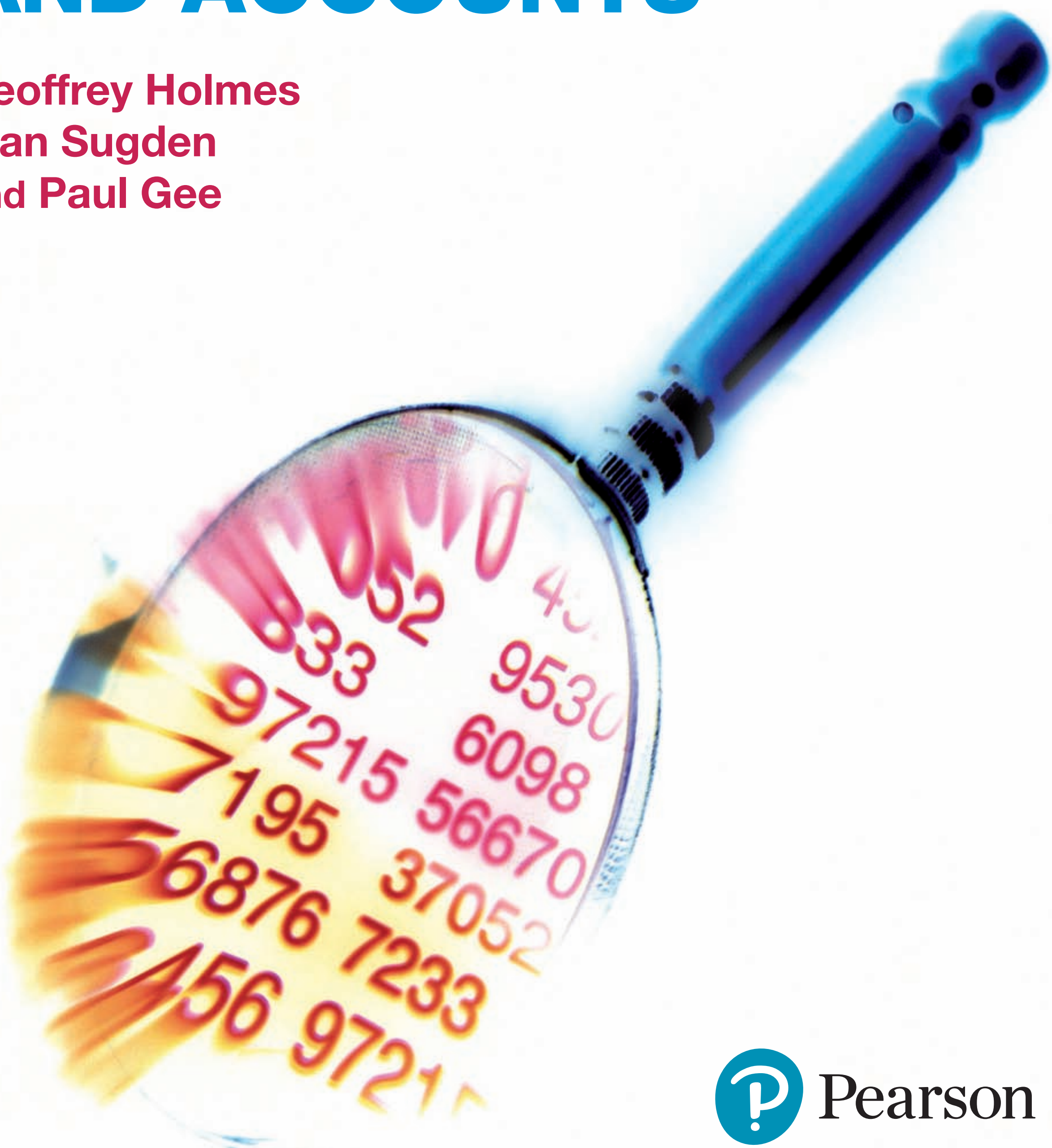

Pearson

Interpreting Company Reports and Accounts

CHAPTER 11

Equity statements, dividends and prior period adjustments

Introduction

In Chapter 1, we referred to the four main primary statements under UK GAAP, namely:

1. the profit and loss account,
2. the statement of total recognised gains and losses (STRGL),
3. the balance sheet,
4. the cash flow statement.

This chapter deals with STRGL and a further statement, the movement in shareholders funds. Equity dividends are also dealt with in this chapter – current accounting practice does not allow equity dividends to be passed through the profit and loss account. We refer also to an additional equity statement required by IFRS.

The statement of total recognised gains and losses (STRGL)

STRGL is a primary statement required by FRS 3, Reporting Financial Performance. The purpose of STRGL is to bring together in a single statement all gains and losses, including those which UK GAAP does not allow to be included in the profit and loss account. STRGL effectively shows the extent to which shareholders' funds have increased or decreased from all gains and losses recognised in the period.

STRGL will usually contain the following elements:

- profit or loss for the financial year (this is the number taken from the final line in the profit and loss account);
- surpluses and deficits on the revaluation of fixed assets (see Chapter 13);
- foreign currency translation differences (see Chapter 29);
- prior period adjustments (see later in this chapter).

The need for such an equity statement was illustrated by the celebrated case of POLLY PECK: the company took an adverse exchange rate variance of £170.3m on net investment overseas direct to reserves in 1988, a year in which it only made an operating profit of £156.9m. The exchange variance was due largely to borrowing in Deutschmarks (DM) and Swiss francs (SFr), where interest rates were low, while keeping money on deposit in very soft Turkish lira. The very high interest received on the soft currency deposits was credited to the profit and loss account, while the capital loss was taken straight to reserves, together with the increase in the sterling value of DM and SFr borrowings. This portent of disaster was missed by some analysts and by most shareholders, but would have been obvious from a STRGL.

STRGL normally appears immediately after the profit and loss account. The following examples show the types of items which might appear in a STRGL.

Examples of STRGLs

Statement of total recognised gains and losses for the year ended 31 December 2007

	2007	2006
	£	£
Profit for the period	455,000	421,500
Other recognised gains – surpluses on revaluation of fixed assets	450,000	300,000
Total recognised gains and losses relating to the period	905,000	721,500

EMI GROUP ***Interim statement 2003***

Statement of total recognised gains and losses for the six months ended 30 September 2003 (unaudited)

	Six months ended 30 Sep 2003		*Six months ended 30 Sep 2002*	
	£m	£m	£m	£m
Profit for the period:		8.8		138.4
Currency retranslation – Group	11.1		7.1	
Currency retranslation – Joint venture and associates	(0.2)		(0.2)	
Other recognised gains		10.9		6.9
Total recognised gains and losses relating to the period		19.7		145.3

Reconciliation of movement in shareholders' funds

FRS 3 also requires (paragraph 28) companies to provide a note reconciling the opening and closing totals of shareholders' funds for the period. Often this follows the statement of total recognised gains and losses but sometimes it is found in the note on reserves.

Typically the change in shareholders' funds which it discloses represents:

(a) transfer from profit and loss account, i.e.
   (i) profit attributable to shareholders, less
   (ii) dividends;
(b) unrealised profit (deficit) on revaluation of fixed assets (normally properties);
(c) currency translation differences;
(d) new share capital subscribed (net);
(e) purchase of own shares;
(f) prior year adjustments.

A basic example follows:

Example 11.1 Reconciliation of movements in shareholders' funds statement

	2007	2006
	£	£
Shareholders funds at 1 January	3,186,500	3,016,500
Profit for the financial year	455,000	421,500
Dividends paid	(185,000)	(130,000)
Other recognised gains and losses relating to the year – surplus on revaluation of property	450,000	300,000
Shareholders' funds at 31 December	3,906,500	3,186,500

Prior period adjustments

Definition

The term prior period adjustment(s) (frequently referred to by the older term 'prior year adjustment') is defined as a material prior period item(s) which is (are) the result of:

- changes in accounting policies, or
- the correction of fundamental errors.

Changes in accounting policies

In Chapter 3 we referred to the fundamental principle of *comparability* (sometimes referred to as *consistency*) and referred to FRS 18 which basically says that: 'Users need to be able to able to compare an entity's financial information over time in order to identify trends in its financial performance and financial position. They also need to be able to compare the financial information of different entities in order to evaluate their relative financial performance and financial position.'

When companies change their accounting policies, figures for the previous year should be restated in line with the new policy so that current and previous year figures are comparable. Comparability between companies can be distorted by companies adopting different accounting policies.

NETCALL below gives disclosure of the impact of the policy change on individual line items. This disclosure is more detailed than that normally required by UK GAAP and was based on extensive disclosures of IFRS (paragraph 28 of IAS 8, Accounting policies, changes in accounting estimates and errors).

NETCALL *Extract from the Annual Report 2003*

Note 1 (Extract)

1. **Accounting policies**
   The financial statements are prepared in accordance with applicable accounting standards. The particular accounting policies adopted are described below. They have all been consistently applied throughout the year and the preceding year with the exception of the policy for recognising maintenance and support revenue for the first year of a supply agreement (refer to note 3).
   . . .
3. **Prior year adjustment**
   During the year the group changed its accounting policy for maintenance and support income for the first year of a supply agreement. Previously this income had been recognised in full upon installation of the system. The current policy is to spread the first year support and maintenance revenue over the year rather than in full upon installation. As a consequence of the company changing its accounting policy in this regard, a prior year adjustment has resulted and the prior year results restated accordingly.

The effect of the prior year adjustment is as follows:

	2002
Turnover	£
Turnover as previously stated	861,231
Effect of prior year adjustment	(53,667)
Turnover as restated	807,564
Increase in loss for the financial year	(53,667)

	2002
Accruals and deferred income	£
Accruals and deferred income as previously stated	148,667
Effect of prior year adjustment	53,667
Accruals and deferred income as restated	202,334
Decrease in net assets	(53,667)

The correction of fundamental errors

FRS 3 paragraph 63 explains the above term:

> ‘In exceptional circumstances it may be found that the financial statements of prior periods have been issued containing errors which are of such significance as to destroy the true and fair view and hence the validity of those financial statements. The corrections of such fundamental errors and the cumulative adjustments applicable to prior periods have no bearing on the results of the current period and they are therefore not included in arriving at the profit or loss for the current period. They are accounted for by restating prior periods, with the result that the opening balance of retained profits will be adjusted accordingly, and highlighted in the reconciliation of movements in shareholders’ funds. As the cumulative adjustments are recognised in the current period, they should also be noted at the foot of the statement of total recognised gains and losses of the current period.’

Two disclosure examples follow (Examples 11.2 and 11.3):

Example 11.2 Note 5 – Prior year adjustment

As referred to in the Directors’ Report, an accounting irregularity was discovered at Bromsgrove which was announced to shareholders on 10 April 2007. Accordingly, the group has made an adjustment of £425,000 to reduce the 2006 profit and loss account to correct the effect of this irregularity.

The effect of these adjustments on the 2006 group profit and loss account are summarised below:

	2006
	£000
Turnover overstated	4
Cost of sales understated	581
Administration expenses understated	5
	590
Corporation tax charge overstated	(165)
	425

The effect on the group balance sheet at 31 March 2006 was as follows:

	2006
	£000
Stocks overstated	556
Trade debtors overstated	4
Other debtors overstated	25
Other taxes and social security costs understated	5
Corporation tax creditor overstated	(165)
	425

Example 11.3 Note 2 – Accounting errors

Credit notes of £1.5m accounted for in the year ended 27 April 2006 and related invoices subsequently received were incorrectly recorded in the profit and loss account. In the light of new information made available to the Board these entries have been reversed. The impact of these adjustments is to increase the profit before tax for the year ended 26 April 2007 by £0.4m (see note . . .). The impact on the balance sheet as at 26 April 2007 is to reduce net assets by £1.1m before tax (see note . . .). £0.8m relates to the year ended 27 April 2007 and is accounted for as a prior year adjustment (see note . . .).

Equity dividends

Accounting treatment

FRS 25, Finance instruments – Presentation and Disclosure, brought in a change to the long-standing treatment of equity dividends. Prior to FRS 25, equity dividends were presented in the profit and loss account as a deduction in arriving at retained profit. Furthermore, in accordance with accounting standards and Companies Act 1985, proposed equity dividends (recommended by the directors for approval by shareholders in annual general meeting) were included in the balance sheet as a liability.

This all changed with effect from accounting periods starting on or after 1 January 2005. Current accounting standards and law require equity dividends paid to be shown as a movement on profit and loss reserves. Effectively equity dividends are regarding as a transaction with the shareholders, and not a finance cost to be charged to the profit and loss account (the special case of preference dividends is referred to below).

Proposed final dividends are a memorandum disclosure and not entered in the accounting records until approved by the shareholders. So dividends proposed in relation to the current period will not be entered in the company's accounting records until the following period.

Example 11.4 Profit and loss reserves note

	£
Profit and loss account at 1 July 2006	550,000
Profit for the financial year	350,000
Dividends paid	(100,000)
Profit and loss account at 30 June 2007	800,000

Equity dividends proposed

Equity dividends proposed are dealt with by memorandum disclosures. They do not become a legal liability until approved by the shareholders at the annual general meeting after the year end. The Companies Act 1985 requires the proposed dividend to be disclosed in a memorandum note as shown in the example below.

Note 10 – Dividends

	£
Dividends paid:	
Final dividend in respect of the year ended 31 March 2005 (. . . pence per share)	105,000
Interim dividend in respect of the year ended 31 March 2007 (. . . pence per share)	80,000
	185,000

The Directors have proposed a final dividend in respect of 2007 amounting to £120,000. This will be recommended to the shareholders at the company's annual general meeting.

(The dividend of £120,000 will be recorded, when it is paid, in the accounts for the year to 31 March 2008, and will be shown as a movement on profit and loss reserves.)

Change of accounting policy

The following example relates to a change of accounting policy relating to the treatment of proposed equity dividends:

> ***Note 1 – Accounting policies (extract): Prior year adjustment***
>
> During the year, the company adopted FRS 21, Events after the balance sheet date and FRS 25, Financial instruments: Disclosure and presentation.
>
> In previous years, equity dividends proposed by the Board of Directors were recorded in the financial statements and accrued as liabilities at the balance sheet date, and equity dividends paid and proposed were recorded in the profit and loss account.
>
> This policy has been changed, and equity dividends proposed by the Board are not recorded in the financial statements until they have been approved by the shareholders at the Annual General Meeting. Equity dividends paid are dealt with as a movement on retained profits.
>
> The change in accounting policy has been dealt with by way of prior year adjustment, and comparative accounts have been restated.

What to consider when paying a dividend

In deciding what profits to distribute the directors of a company should have in mind:

- the company's cash position;
- what is prudent;
- what is legally permissible.

Ideally, directors should choose the lowest of these three figures.

What is prudent?

In deciding what would be prudent, directors should weigh up the cost of raising capital in various ways. Is it, for instance, better to borrow (i.e. increase the gearing) rather than ask equity shareholders to contribute more towards the net assets of the company? And, if equity shareholders are to be called upon to provide more, should they be asked to do so by means of a rights issue, in which case each shareholder has the choice of whether to take up, or sell, his or her rights; or should profits be 'retained', in which case the individual shareholder has no choice?

Unfortunately, the picture is confused by inflation and the present, historical cost, method of accounting. With no inflation (or an inflation accounting system recognised for tax purposes) a company would, in theory, be able to distribute its earnings and still maintain its assets in real terms. With inflation most companies need to retain a proportion of their earnings as calculated by historical cost accounting in order to maintain their assets in real terms (but more of that in Chapter 31).

Having decided how much it is necessary to retain in order to continue the existing scale of operations, and how much should be retained out of profits in order to expand the scale of operations, the directors should look at what remains.

Ideally, a company should pay a regular, but somewhat increasing, dividend. For example, from a market point of view, it is preferable to pay: 8.0p; 9.0p; 9.0p; 9.0p; 9.5p; 10.0p; rather than 8.0p; 12.0p; 10.5p; 4.0p; 10.0p; 10.0p – though both represent the same total sum in dividends over the six years – because investors who need steady income will avoid companies which are erratic dividend payers, and because a cut in dividend undermines confidence in the company's future. In other words, the directors of a company should think twice before paying a dividend this year which they may not be able to maintain, or setting a pattern of growth in the rate of dividend which could not reasonably be continued for the foreseeable future. For if they do either of these things, they are liable to disappoint shareholder expectations, to damage their market rating and to see their share price slashed if their dividend has to be cut or the rate of dividend growth cannot be sustained.

What is legally permissible?

Companies are allowed to distribute only the aggregate of accumulated realised profits not previously distributed or capitalised less accumulated realised losses not previously written off in a reduction or reorganisation of capital (CA 1985, s. 263). The word 'realised' is not defined in the Act, but FRS 18 says that profits should be included in the profit and loss account 'only when realised in the form either of cash or of other assets the ultimate cash realisation of which can be assessed with reasonable certainty'.

In addition, a public company may pay a dividend only if the net assets of the company after payment of the dividend are not less than the aggregate of its called up share capital and undistributable reserves (s. 264(1)). Undistributable reserves are defined in s. 264(3) as:

- share premium account;
- capital redemption reserve;
- accumulated unrealised profits not capitalised less accumulated unrealised losses not previously written off in a capital reduction or reorganisation;
- any reserve which the company's memorandum or articles prohibits being distributed.

This requirement means that public companies now have to cover net losses (whether realised or not) from realised profits before paying a dividend.

Where the company's audit report has been qualified, the auditor must provide a statement in writing as to whether the qualification is material in deciding whether the distribution would be a breach of the Act, before any distribution can be made.

Recent guidance

- ICAEW/ICAS Technical Circular 02/07 on Distributable profits: Implications of IFRS;
- www.icaew.co.uk – click on Technical and Business Topics, then Technical Releases.

Preference dividends

Preference dividends that the company is required to pay (i.e. dividend payments over which directors have no discretion) must be shown as a finance cost in the profit and loss account. Note the following:

- preference shares carry a fixed rate of dividend, normally payable half-yearly;
- preference shareholders have no legal redress if the board of directors decides to recommend that no preference dividends should be paid;
- if no preference dividend is declared for an accounting period, no dividend can be declared on any other type of share for the period concerned, and the preference shareholders usually become entitled to vote at shareholders' general meetings;
- if the dividend on a cumulative preference share is not paid on time, payment is postponed rather than omitted and the preference dividend is said to be 'in arrears', and these arrears have to be paid before any other dividend can be declared. Arrears of cumulative preference dividends must be shown in a note to the accounts.

(See also Chapter 22.)

Equity statements under IFRS

IAS 1, Presentation of financial statements, requires the following to be shown on the face of the equity statement:

- the profit or loss for the period;
- each item of income or expense that, as required by the other Standards, is *recognised directly in equity*, and the total of these items; and
- the cumulative effect of changes in accounting policy and the correction of errors recognised under IAS 8.

In addition, the following must be presented within *either* the statement of changes in equity *or* in the notes:

- the amounts of capital transactions with equity holders and distributions to equity holders (i.e. equity dividends paid);
- the balance of retained earnings at the beginning of the period and at the balance sheet date, and the movements for the period; and
- a reconciliation between the carrying amount of each class of equity share capital, share premium and each reserve at the beginning and the end of the period, separately disclosing each movement.

Format alternatives

The above requirements may be satisfied by adopting either of two formats:

- **format 1** – a columnar format that reconciles opening and closing balances for *each* element within equity (Example 11.5);
- **format 2** – to present only the items specified in IAS 1.96 above (the statement using this format is usually referred to as the 'Statement of recognised income and expense'). If this format is used, the movement on share capital and each reserve category must be disclosed in the notes to the financial statements (Example 11.6).