

A brief overview of financial statements

The purpose of these notes is to give a very brief overview of financial statements. It serves as a refresher for those with some previous knowledge of accounting and as a first exposure for others. It is intended that students will have a set of accounts to hand.

1. Main statements

The main statements to be found in UK accounts are:

the balance sheet

a *stock* (or levels) statement concerning the stock of assets held by a company and how they are financed. The finance section is usually split in to (i) financing by shareholders (ii) financing from other sources.

the profit and loss account

a *changes* statement concerning how the assets of the shareholders (the net assets) have changed over a period.

statement of total recognised gains and losses (STRGL)

this is a *change* statement, but shows all the gains and losses (and not just those that have been recognised in the profit and loss account) for the period. The STRGL of most companies starts with profit figure and then includes those items which have been recognised as reserve movements.

the cash flow statement

this is also a *changes* statement, similar to the profit and loss, but of cash changes during a period. It also differs from the profit and loss in that it deals with the cash flows of the *business*, whereas the focus of the profit and loss is the shareholders.

the notes to the accounts

they give more detail than in the main statements

These are now considered in turn.

2. The balance sheet

| Assets - Debit balances | £ | Financing - Credit balances | £ |
|--------------------------------|------------|------------------------------------|------------|
| Fixed assets | | Current liabilities | - |
| plant & equipment | - | Long term liabilities | - |
| Current assets | | Shareholders' interest | |
| cash | - | share capital | - |
| debtors | - | retained profit | - |
| stock | - | profit & loss for the year | - |
| Total assets | === | Total liabilities | === |

The shareholders' interest is divided between:
capital raised by the company through share issues;
retained profit from previous years;
profit and loss for the year.

The format of the balance sheet in the UK is governed by the Companies Act 1985 (Sch 4).

I - TRADITIONAL FINANCIAL STATEMENT ANALYSIS

One of the techniques used to examine the financial position of the company is financial statement analysis. This uses components of the balance sheet to identify various characteristics of the company, which are:

liquidity;

profitability; and

risk.

There are many books on these matters and exactly how a particular characteristic is measured varies. The following is indicative only.

Liquidity

The purpose of the liquidity measure is to assess the extent to which the business can continue to operate in the short term. Typically the ratio used is

- $\text{current assets} / \text{current liabilities}$

since current liabilities measure the short term outgoings of the company and the current assets measure the short term resources. It is sometimes called the quick ratio.

Profitability

This ratio measures the resources gained by the company in relation to the assets at its disposal. One ratio used for this focusses on the return to shareholders

- $\text{profit \& loss for the year} / \text{shareholders' interest}$

whilst another focusses on the company as a whole

- $\text{profit \& loss for the year} + \text{interest paid} / \text{total assets}$

Risk

The purpose of this measure in traditional financial statement analysis is to assess the extent to which the shareholders are exposed because long term loans have been raised. There are two main measures used for this:

- $\text{long term liabilities} / \text{total assets}$ (which focusses on the proportion of assets financed by debt)
- $\text{interest payments during the year} / \text{profit \& loss for the year} + \text{interest paid}$ (which focusses on the proportion of income paid to debt holders)

Although this analysis is useful, other risks have come to the fore in recent years particularly

risk from foreign exchange and interest rate movements. This is mentioned again below

3. The profit and loss statement

It can be seen from the balance sheet that the underlying assets represented by the shareholders' interest is:

Fixed assets + Current assets - Current liabilities - Long term liabilities.

It can also be seen below, that the profit and loss captures the changes in the shareholders' interest during a period.

Balance sheet at 31/12/98

| Debit balances | £ | Credit balances | £ |
|-----------------------|----------|----------------------------|----------|
| Fixed assets | | Current liabilities | 5 |
| plant & equipment | 100 | Long term liabilities | 5 |
| Current assets | | Shareholders' interest | |
| cash | 10 | share capital | 80 |
| debtors | 5 | retained profit | 40 |
| stock | 25 | profit & loss for the year | 10 |
| | === | | === |
| | 140 | | 140 |

Balance sheet at 31/12/99

| Debit balances | £ | Credit balances | £ |
|-----------------------|----------|------------------------|----------|
| Fixed assets | | Current liabilities | 5 |
| plant & equipment | 100 | Long term liabilities | 5 |
| Current assets | | Shareholders' interest | |
| cash | 10+5 | share capital | 80 |
| debtors | 5 | retained profit | 40+10 |
| stock | 25-4 | p&l for the year | +5 -4 |
| | === | | === |
| | 140 | | 140 |

The shareholders' interest at 31/12/98 is 130, including 10 being the profit for the year. If no dividends are paid then this profit is transferred to retained profit in the balance sheet at 31/12/99. The p&l for the year ended 31/12/99 is 1 (5 cash received from sales, less 4 for the cost of the stock sold). The shareholders' interest is at 31/12/99 is 131.

The detailed rules for the presentation of the profit and loss are given in FRS 3 Reporting Financial Performance. Its key features are:

- ✓ Lines of the p&l down to operating profit, need to distinguish between different types of activities according to whether they were:
 - discontinued in the year
 - continued from previous year
 - acquired during the year and are to be continued
- ✓ Items which are exceptional must be shown on the face of the p&l.
- ✓ earnings per share *includes* any extraordinary items.
- ✓ ordinary activities of the company are defined so widely so as to minimise the occurrence of an extraordinary item.

4. Statement of total recognised gains & losses (STRGL) sometimes called 'comprehensive income'

Sometimes charges to shareholders equity are not made to the profit & loss account for the year, but are charged to retained profit (often called reserves).

An example might be foreign currency translation. Suppose that the company owns an asset denominated in the US \$, say \$100. At 31/12/98 the rate may be £1=\$1.5, in which case the asset would be included in the balance sheet at £66.67. If at 31/12/99 the rate is £1=\$1.6, then the asset will be recorded at £62.50; a loss of £4.17. According to UK practice (SSAP 20 Foreign Currency Translation) this loss will be charged to reserves; that is clean surplus accounting¹ will be violated.

FRS 3 requires that the majority of these types of gain and loss, which are charged to reserves, should be included in the STRGL. When, in addition, the profit for the year is included, the STRGL gives a complete picture of gains and losses made by the company during the year. This is called comprehensive income.

The main argument which has been used to justify a statement of comprehensive income is that these gains and losses, which are charged to reserves, are in fact part of the financial performance of the company. Because they may be temporary or because they arise from financial markets (rather than from trading in real assets), shareholders need to be aware of them. But what is wrong with disclosing these items as part of the movements in reserves (a statement of stock holders equity) ?

The answer is that they would be jumbled up with other types of items (such as capital movements) and it may be that investors would not appreciate their significance. In fact, research by Maines & McDaniel supports this view². They find that non professional investors understand the gains and losses in a statement of comprehensive income but do not understand them when they are presented in a statement of stockholders' equity.

¹This is defined as when all gains and losses, recorded in the accounts during the year, are located in the profit and loss account.

² "Effects of comprehensive income characteristics on non-professional investors' judgements: the role of financial statement presentation format", Accounting Review, April 2000.

Statements of comprehensive income are permitted by IAS 1 but are not generally used. The G4+1 (UK, USA, Canada, Australia + IASC) have recently³ argued for a single performance statement with headings as follows:

operations;
financing & treasury;
other.

5. The cash flow statement

The cash flow statement is necessary because the profit and loss account does not always deal with cash. In particular:

transactions are recognised before cash changes hands, eg credit sales (£10 in the example below);

some transactions recorded by the company's accounting system have no real world counterpart, they are in effect *internal transactions*, eg depreciation of fixed assets (£5 in the example below).

In the example below, credit sales of £10 are made and plant & equipment is depreciated by £5.

| Debit balances | £ | Credit balances | £ |
|-----------------------|----------|------------------------|----------|
| Fixed assets | | Current liabilities | - |
| plant & equipment | -5 | Long term liabilities | - |
| Current assets | | Shareholders' interest | |
| cash | - | share capital | - |
| debtors | +10 | retained profit | - |
| stock | - | p&l for the year | -5 |
| | | | +10 |
| | === | | === |

The detailed rules for the presentation of the cash flow statement are given in FRS 1 Cash Flow Statements. The headings for cash flows required by the standard are:

- ✓ operating activities
 this can be gross amounts received less gross amounts paid, but it is typical to calculate this from operating profit
 = operating profit + non cash charges - non cash revenues
- ✓ dividends from joint ventures & associated undertakings
- ✓ returns on investment + servicing of finance

³ Accountancy, February 1998, pages 4 & 88

- ✓ tax paid
- ✓ capital expenditure & financial investment (eg purchase of fixed assets)
- ✓ acquisitions & disposals (eg companies purchased as going concerns)
- ✓ equity dividends paid

This cash outflow (inflow) under the above headings will have resulted in any of the following:

- ✓ decrease (increase) in liquid resources (money on short term deposit) ⁴
- ✓ increase (decrease) in debt
- ✓ decrease (increase) in cash

6. Group accounts

Companies will tend to have a variety of relationships with other economic businesses, and it is important to know how these are dealt with in the company's performance statement. The main relationships that a parent company is likely to have are:

Subsidiary: in this case the parent exercises dominant influence, either by owning a majority of shares or by being able to appoint a majority of the directors;

Associated company: in this case the parent holds a participating interest and exercises significant influence. A holding of 20% of shares is presumed to be a participating interest.

Joint venture: in a joint venture, there is established an entity which has some operational independence from the venturers, but all venturers have a veto on strategic decisions.

The accounting for these three types of activities is discussed briefly below.

I - ACCOUNTING FOR SUBSIDIARIES (ACQUISITION ACCOUNTING)

The accounting treatment is usually acquisition accounting. Here, the investment in the parent accounts is replaced by the underlying assets of the subsidiary. If the parent does not own all of the subsidiary, then the liabilities need to show a minority interest. This method is a clear way of showing investors the assets and liabilities over which the group has control. Some examples of the key features of acquisition accounting follow.

⁴ It is worth noting that in FRS 1, cash is *exactly* that. Near cash is therefore treated as liquid resources.

The simple case is when, in the parent's accounts, the investment in the subsidiary exactly mirrors the net assets of the subsidiary, as in the following case.

| | Parent | Subsidiary | Group |
|----------------------------|--------|------------|-------|
| Fixed assets | 100 | 9 | 109 |
| Current assets | 20 | 3 | 23 |
| Investment in sub | 10 | | |
| less | | | |
| Liabilities | 10 | 2 | 12 |
| | ---- | ---- | ---- |
| Net assets | 120 | 10 | 120 |
| | ---- | ---- | ---- |
| Owners' equity at takeover | 120 | 10 | 120 |

However, the case is a special case in that the book value of the parent's investment is the same (10) as the net assets of the subsidiary. This may not always be the case because of:

1. Post acquisition profits. After the takeover, the subsidiary will earn profits. If these post acquisition profits are not reflected in the book value of the parent's investment, then some adjustment in the group accounts is needed.

| | Parent | Subsidiary | Group |
|----------------------------|--------|------------|-------|
| Fixed assets | 100 | 9 | 109 |
| Current assets | 20 | 7 | 27 |
| Investment in sub | 10 | | |
| less | | | |
| Liabilities | 10 | 3 | 13 |
| | ---- | ---- | ---- |
| Net assets | 120 | 13 | 123 |
| | ---- | ---- | ---- |
| Owners' equity at takeover | 120 | 10 | 120 |
| Post acquisition profits | | 3 | 3 |

2. Minority interests. The parent may not have purchased 100% of the subsidiary.

| | Parent | Subsidiary | Group |
|----------------------------|--------|------------|-------|
| Fixed assets | 100 | 9 | 109 |
| Current assets | 20 | 3 | 23 |
| Investment in sub (80%) | 8 | | |
| less | | | |
| Liabilities | 10 | 2 | 12 |
| | ---- | ---- | ---- |
| Net assets | 118 | 10 | 120 |
| | ---- | ---- | ---- |
| Owners' equity at takeover | 118 | 10 | 118 |
| Minority interests | | | 2 |

3. Goodwill. The parent may have paid for the subsidiary an amount in excess of the net assets of the subsidiary.

| | Parent | Subsidiary | Group |
|----------------------------|--------|------------|-------|
| Fixed assets | 100 | 9 | 109 |
| Current assets | 20 | 3 | 23 |
| Investment in sub | 14 | | |
| Goodwill on consolidation | | | 4 |
| less | | | |
| Liabilities | 10 | 2 | 12 |
| | ---- | ---- | ---- |
| Net assets | 124 | 10 | 124 |
| | ---- | ---- | ---- |
| Owners' equity at takeover | 124 | 10 | 124 |

4. All of these factors may be combined in one example as follows:

Fair value of assets at acquisition = 10
 Parent purchased 80% of subsidiary
 Purchase price = 12
 Post acquisition profits of subsidiary = 5

| | Parent | Subsidiary | Group |
|-------------------------------------|--------|------------|-------|
| Fixed assets | 100 | 9 | 109 |
| Current assets | 20 | 9 | 29 |
| Investment in sub (80%) | 12 | | |
| Goodwill on consolidation | | | 4 |
| less | | | |
| Liabilities | 10 | 3 | 13 |
| | ---- | ---- | ---- |
| Net assets | 122 | 15 | 129 |
| | ---- | ---- | ---- |
| Owners' equity at takeover | 122 | 10 | 122 |
| Post acquisition profits | | 5 | 4 |
| Minority interests at takeover | | | 2 |
| Minority interests post acquisition | | | 1 |

II - ACCOUNTING FOR ASSOCIATES AND JOINT VENTURES

The accounting treatment for associates and joint ventures is normally equity accounting. The associated company is kept as a one line investment at cost, but any profits of the associate (irrespective of receipt) are included in the investment and the group p&l. The treatment is required by IAS28 Accounting for investments in associates.

An alternative sometimes allowed, for example by IASC, is proportional consolidation. Here, the investment in the parent accounts is replaced by the % of the underlying assets and liabilities owned by the parent. Obviously, this treatment does not allow for minority interests. Graham, King and Morrill, *Accounting Horizons*, June 2003 find that proportionate consolidation the more informative than equity accounting. However, the problem is that these assets are *not* really under the control of the parent. Proportionate consolidation is the benchmark treatment for joint ventures by IAS3, but the allowed alternative is equity accounting as required in UK (FRS 9).

Example of equity accounting for associate

- parent owns 20%
- 20% of profits after purchase (=25) included in group equity

| | Parent | Assoc | Group |
|--|--------|-------|-------|
| Fixed assets | 100 | 55 | 100 |
| Current assets | 20 | 30 | 20 |
| Investment in assoc | 10 | | 15 |
| less | | | |
| Liabilities | 10 | 10 | 10 |
| ---- | ---- | ---- | |
| Net assets | 120 | 75 | 125 |
| ---- | ---- | ---- | |
| Owners' equity | 120 | 50 | 120 |
| Profits since purchase of associate | | 25 | 5 |

7. Accounting principles

Many of the traditional accounting principles are transaction driven:

the accruals principle allows non cash transaction to be included;

the matching principle means that some expenditures are not charged to the p&l in the year of the expenditure, but some amount is carried forward as an asset to be charged (amortised) at a later date.

Over the past few years, many accounting regulators (ASB, IASC & FASB) have changed the focus of accounting principles. For example, a revised exposure draft of the ASB's Statement of principles for financial reporting was issued in March 1999⁵ and its contents are much the same as the principles statements of other major regulators.

The effect of the new statements is that before a transaction is considered for recognition, it has to satisfy the definition of an asset or a liability. This seems to make sense since, at the end of the day, a transaction will be disclosed on the balance sheet, either as an asset or as a liability. However, the definitions are rather strict:

Assets are rights or other access to future economic benefits controlled by an entity as a result of past transactions or events. (para 4.7 Revised ED, Statement of principles for financial reporting)

Liabilities are obligations of an entity to transfer economic benefits as a result of past transactions or events. (para 4.24 Revised ED, Statement of principles for financial reporting)

One area that this has affected is the use of provisions.

| | | | |
|-----------------------|----------|------------------------|----------|
| Debit balances | £ | Credit balances | £ |
| Fixed assets | | Current liabilities | +7-5 |

⁵ It is reproduced in Accountancy, April 1999, page 123-144.

| | | | |
|-------------------|-----|------------------------|-----|
| plant & equipment | - | Long term liabilities | - |
| Current assets | | Shareholders' interest | |
| cash | -5 | share capital | - |
| debtors | - | retained profit | - |
| stock | - | p&l for the year | -7 |
| | === | | === |

A provision of £7 is set up through a charge to the p&l and establishing a liability. When the expenditure is undertaken, say £5, then it is charged to the liability and not the p&l.

This accounting practice allows companies to inform shareholders about future expenditures without waiting until they occur. It also allows a company to spread charges to the p&l over a number of years, even though the expenditure takes place over a narrower time frame.

For example:

oil companies tended to account for oil spills in this way;

also many companies operate a policy of self insurance and therefore prefer to make annual provisions on the basis of expected future expenditure.

When a provision made is no longer needed, because for example the initial estimate was too large, then the liability would be written back to the p&l, in this case £2. As well as giving scope for managers to inform shareholders, there is also clear scope for earnings manipulation.

Under the new accounting principles (implemented in the UK by FRS 12 Provisions, contingent liabilities and contingent assets) a provision may be made only if the resultant liability satisfies the definition previously given.

Liabilities are obligations of an entity to transfer economic benefits as a result of past transactions or events. (para 4.24 Revised ED, Statement of principles for financial reporting)

In many cases the liability does not meet the above definition; for example, before an oil spill has happened there is no obligation on the part of the company to undertake any expenditure. Therefore under the new accounting principles, these provisions may not be made and companies may recognise events only after they have happened, leading to an increased volatility of the p&l figure.

This increased volatility of the p&l is an important and continuing feature of many of the accounting standards being developed by the international regulators.

8. Current value or historical cost accounting?

The vast majority of accounting is based on historical cost. The value of an asset or liability is its cost, and that is how it remains ⁶. However, there are some who think that current value

⁶unless of course the asset is impaired and its value needs to be revised downwards.

would be more useful. Consider the following example.

A company buys 3 units of stock for \$30, and then a few months later sells them for \$54. However, at the time of sale the units of stock could have been purchased by the company for \$36.

$$Y_{hc} = \text{historical cost profit} = \$54 - \$30 = \$24$$

But

$$Y_{cv} = \text{current value profit} = \$54 - \$36 = \$18$$

The rationale for current value is that the operating profit is \$18, and that \$6 profit has been made by holding the stock. Current value accounting separates profit from operations from profit from holding. The rationale is that the permanence of the two components might be different (for example, price rises may not continue), and this is something that shareholders might need to know in estimating future performance.

This is fine as far as it goes. However,

Essentially, current value defines profit as actual revenue (actual price x actual quantity) with hypothetical costs (replacement price x actual quantity). The rationale for these hypothetical costs is that they reflect the expenditure needed for the company to replace the unit of stock). However, the important point is that the hypothetical costs may not be a good predictor of future cash generating ability of the company since it ignores:

(i) any adjustments to "actual quantity" that the company might make next period (recall that most economic models of firm behaviour suggest that when costs rise, the firm will produce less)

(ii) any increases in "actual price" that the company may succeed in passing on to its customers.

Therefore current value profit is only a partial view of future sustainable performance. Some argue that historical cost profit is in fact a better guide to the future. These issues are discussed in some detail in:

Ovadia & Ronen, On the Value of Current-Cost Information, *Journal of Accounting Auditing and Finance*, Winter 1983, 115-129; and

Skerratt, The bias in current cost income: an extension, *Journal of Accounting, Auditing and Finance*, Summer 1984.

9. Risk

Investors are concerned with risk as well as return. An important development over the past decade is that companies can now enter financial markets and can transform their risk profile dramatically, even though the economic risk of the business may remain constant. A company may change its risk profile by transactions in the financial market just as much as by transactions in the real market. A good discussion of the issues can be found in the ASB's Discussion Paper, *Derivatives and Other Financial Instruments*, 1996⁷.

⁷ Much of this review is based on the ASB Discussion Paper.

For example, a company may enter in to a swap arrangement to pay variable interest and receive fixed interest. This has the effect of transforming a fixed interest loan in to a variable interest one. Furthermore, since a swap may be costless it will not be recognised by the accounting system and therefore investors may not be well informed. Even when the transaction is not costless, the impact that it may have on the company performance far exceeds its value recorded in the accounts. An important issue, therefore, is how can the accounts *fully reflect* these activities?

I - INCREASING COMPANY INVOLVEMENT WITH FINANCIAL INSTRUMENTS

One of the reasons for increased involvement in financial markets is to raise capital at the lowest cost. They have the choice of financial instrument (debt/convertible/equity) but also a choice of currency. For example, a company may raise its finance in a foreign currency because of (a) lower rates of interest in that country and (b) its expectations about the rate of exchange between sterling and the local currency. It may also decide to exchange its fixed rate loan for a variable rate one by obtaining a swap (in this case an agreement to receive a fixed amount, equal to the loan interest it currently pays, and to pay an amount which varies with market interest rates).

Another reason for company involvement in financial markets is a consequence of their trading operations. For example, when a company sells its products in the USA, then the products may be priced in terms of dollars. A sale on credit is then made up of three components:

- a real transaction, the sale of goods, on credit, for dollars;
- a financial transaction, a loan to the customer, in dollars; and
- a financial transaction, converting the dollars in to sterling when the dollar loan is paid.

So apart from facing the economic risk of whether sales will take place, the company has additional financial risks:

- a debt risk, concerning whether the customer will pay, in dollars; and
- a foreign exchange risk, concerning the rate of exchange between dollars and sterling when payment is made. It is this risk that may be reduced by purchasing a financial instrument, namely the future sale of dollars (for sterling) at the time when the customer is anticipated to pay the dollars.

II - WHAT ARE THE RISKS?

Two types of risk are generally identified in connection with financial instruments: cash flow risk and market price risk.

Cash flow risk is the risk that the payments made or received by a company under a financial contract will vary. For example: if a company enters in to a “fixed interest for variable interest” swap, then the interest payable on the loan will vary with market interest rates. If a company sells overseas and prices its product in the foreign currency, then the amount it receives *in sterling* from a sale will vary according to the rate of exchange between sterling and the foreign currency.

Market price risk is the risk that the market (or fair) value of the financial instrument will change. For example, if a company raises a fixed interest loan, then the market value of the

loan will change with market interest rates; as market rates rise, the value of the loan will fall. Another example is the raising of funds on foreign markets in the foreign currency; the liability *in sterling* will vary with the exchange rate between sterling and the foreign currency.

III - HOW SHOULD FINANCIAL INSTRUMENTS BE TREATED ?

If financial instruments (and more particularly, the outcomes from the above risks) are to be reflected in the balance sheet and the profit and loss account, then we need to have some principles about how to treat them. The formal definition of a financial instrument is a transaction that

gives rise to a financial asset of one company and a financial liability (or equity instrument) of another company.

The natural questions that arise are:

1. What types of financial instrument should be treated together?

For example, do we need to distinguish between different types of financial instrument, for example between derivatives and non derivatives?

Another problem concerns contracts for raw material commodities such as tea, coffee, silver and gold. Strictly, they are not financial instruments because they are contracts to deliver or supply goods, but they can give rise to much the same risks. In many commodity markets, it is possible to take risk positions which are similar to those in financial markets. Generally, regulators have wanted to include commodity contracts only to the extent that settlement can take place in cash or a financial instrument.

2. Does the intention of how the instrument is expected to be used affect the accounting treatment?

For example, should the treatment of any gains and losses differ according to whether or not the instrument is held for trading or for investment? Should the treatment of any gains and losses differ according to whether or not the instrument is expected to be held to maturity or not?

3. Does the position in the accounts help to determine the treatment?

For example, should the treatment depend on whether the item is an asset or a liability. Should the treatment depend on whether the item gives rise to a gain or a loss

4. Should we have Clear Blue Sky solutions?

One approach to standard setting would be to deal with all financial instruments together. Although this is intellectually tempting, the substantial disadvantage is that the scope of the project would become very wide; proposals and agreement would then much more difficult to achieve.

A more pragmatic approach is to concentrate on the instruments which have given rise to the most problems. This makes sense since the goal of financial reporting is to provide shareholders and others with information about the company. If there are already accepted practices for dealing with some financial instruments, it is sensible to concentrate on those for which no currently acceptable practice exists, particularly if these instruments give rise to the

largest risk. This seems to have been the approach adopted by the FASB in FAS 133 and the IASC in IAS 39.

Support for this practical approach is that, as mentioned above, simple financial instruments such as loans, debtors and creditors have always been a part of company activity and there are well understood (if not totally acceptable) accounting treatments. For example, *FRS 4 Capital instruments* deals with the treatment of debt finance. The treatment for a few of the more complicated financial contracts has also been agreed; *SSAP 21 Accounting for leases and hire purchase contracts* deals with leases and *FRS 17 Retirement benefits* deals with pension obligations.

IV - DISCLOSURE OR MEASUREMENT?

Another issue is whether the financial reporting needs of investors should be met by disclosure. Generally measurement is preferred to disclosure since investors wish to assess the performance of the company. Sometimes where measurement issues are complicated, commentators suggest that disclosures be made so that investors can make their own assessments of company performance; but of course, this is *exactly* the time when investors are typically unable to do it for themselves. If accountants cannot decide on suitable rules to measure performance, there is little hope that investors can do this by themselves.

In the case of financial instruments, measurement rules may take some time to develop and many regulators have taken the view that disclosure is better than nothing. Therefore they have first issued an interim disclosure standard before finalising their views on measurement. For example, the IASC issued IAS 32 "Financial instruments: disclosure and presentation" in March 1995 prior to publishing its standard in March 1999, IAS 39 "Financial instruments: recognition & measurement". The ASB issued a disclosure standard FRS 13 "Derivatives and other financial instruments: disclosures" in June 1997.

V - MARKET VALUE OR HISTORICAL COST?

In traditional areas of accounting, historical cost is used sometimes with the option of using current values (for example in the area of fixed asset accounting). The problem with using historical cost in financial instruments is that the cost of the instrument is relatively small to its potential impact on performance.

For example, a company can swap a fixed interest security for one with variable interest payments for very little cost; and yet the impact of this arrangement on the cash flow risk can be large if there is a subsequent possibility that interest rates will rise substantially. One possibility might be to retain historical cost for those instruments giving rise to relatively low levels of risk, with market values being used for the rest.

A further advantage of keeping track of current values of financial instruments is that they are very close to cash. They can be realised for the cost of a phone call. A historical cost system would allow companies to choose which gains to realise and to report in the accounts. Generally, regulators have preferred market values to historical cost.

VI - SHOULD HEDGING BE RECOGNISED AS A SPECIAL TYPE OF TRANSACTION ?

Rather than simply accepting financial risk or continuously appraising and adjusting their risk position, there are some companies which want to be sure that they reduce their exposure to movements in financial markets. Therefore, when faced with an unavoidable risk in a financial market, they take out insurance; that is they hedge.

For example, a company that raises loan in a foreign currency may do so because of the low interest rates. However, when the loan needs to be paid back, sterling may have weakened and the liability in terms of sterling may be much larger than was expected.

One way round this is to buy the currency at the same time the loan is taken out. That is the company would buy forward; it would pay now (in sterling) for the right to receive the value of the loan (in the foreign currency) in the future when the loan is repayable. Of course there is a price to be paid for this. The rate at which the company can buy foreign currency for the future (the forward rate) will reflect the market's expectations about the future. If there is some general feeling that the sterling will weaken, then the company will have to pay more sterling for delivery in the future than if delivery were now. However, at least the company has some certainty. Whatever happens to sterling, then there is no risk; they will be able to pay off the loan in the foreign currency.

Another example in which a company might hedge is when a company invests abroad. The value of the investment will vary with the value of the foreign currency; this market value risk can be important particularly if funds for the investment have been raised in sterling. In this case, a rise in sterling (relative to the foreign currency) means that the value of the asset is falling, whilst the liability remains the same. Therefore many companies may finance the purchase of an overseas investment by raising the funds in the same foreign currency as the investment. This means that any change in the currency will affect both the value of the asset and the liability. That is, the foreign currency loan is a hedging instrument against the foreign currency investment (the hedged item).

Hedge accounting

The main idea behind hedge accounting is to treat the hedge as a special type of transaction and to make special rules for recording it in the balance sheet and profit and loss account. Essentially, it involves the hedged item and the hedging instrument being treated together, in some sense, in view of the fact that the transactions are economically coupled.

There are two main cases where hedge accounting might be used.

- 1 Where the hedge is measured at current value and the hedged item is measured at historical cost.

If both the hedged item and the hedging instrument are measured at market value, any gains or losses on the hedged item and the hedging instrument can be dealt with in the same accounting period (perhaps they might be offset).

However, it may be that the gains or losses on the item are recognised at a different time to those on the instrument. For example the item may be measured at historical cost (with any gain or loss being recognised only on realisation) and the hedge might be measured at market value. In this case, the gain or loss on the hedging instrument might be kept to one side (that is, out of the profit and loss account) until the item is realised. But where? If the gain/loss is kept in reserves, this has all the problems of reserve accounting. If it is kept within assets and liabilities, then the result is counter-intuitive; gains will land up as a liability and losses will land up as assets.

A significant problem if hedges are to be recognised is the practical one; how do we know that any given instruments is held as a hedge for a given item; is management intent enough?

- 2 Where the hedged item (for example, future sales in a foreign currency) does not exist,

whereas the hedge does exist.

For example, a company anticipates that during the next financial year it will sell \$200m worth of goods in the USA. The current rate of exchange is £1=\$1.6 and the rate is not expected to change. However, in order to be certain about the value of those future dollars it enters in to a contract (at no cost) to sell \$200m in September at the rate of £1=\$1.6. At the end of the current financial year the dollar is £1=\$1.7 and therefore the contract will have a positive value in view of the future gain to be made $[200 \div 1.6] - [200 \div 1.7]$ ⁸. But the sales will now take place at £1=\$1.7 giving less (sterling) revenue than anticipated. Therefore it would make some sense to put aside the gain on the financial contract until the sales are complete.

In this example, the hedge relates to a forecasted transaction. But what happens if the company sells only \$150m of goods, and sterling falls to \$1.5 against the dollar? With hindsight, it would have been better to recognise at least part of the loss on the financial contract at the end of the current financial year, since we now know that part of the financial contract had nothing to do with the sale! So when the company adopts hedge accounting and sets aside the loss at the end of the current financial year, it is never clear if this really represents the economic position of the company.

These problems are part of the issue of whether hedging should exclude forecasted transactions and be confined to contracted transactions.

⁸ The gain is $125 - 117.65 = 7.35$