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ACCOUNTS

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Publication of the annual and interim accounts are a critical component of a board's accountability to shareholders and other stakeholders. The approval and the publishing of the accounts is an activity which cannot be delegated to management or a subcommittee of the board.

Making sure you understand your responsibilities is essential. Generally, directors are individually and collectively responsible for:

- Keeping adequate accounting records
- Preparing financial statements in accordance with laws and regulations
- Selecting suitable accounting policies and applying them consistently
- Making judgements and accounting estimates that are reasonable and prudent
- Preparing accounts on a going concern basis unless it is inappropriate.

Understanding the accounts

It is important to start with a good grounding in the entity's accounts and accounting issues. A board induction programme should include sessions

with key persons in the accounts and accounting process such as the chair, audit committee chair, finance director, and financial controller.

Management should provide a written briefing on the topic. The induction process could also include turning the pages on the last published annual report and accounts, discussing significant matters, and reviewing recent audit committee papers.

The board induction programme should include a review of the laws and regulations affecting the entity. In relation to the accounts that may mean specific provisions in company law covering the responsibilities of directors for accounts and any additional requirements in capital market or securities laws and regulations, auditing standards, and governance codes.

Accounting standards

Company law or securities law will likely prescribe the accounting standards that must be complied with. Many countries have adopted International Financial Reporting Standards (IFRS) or IFRS with some limited adjustments, or other similar national standards.

Directors who are not professional accountants are not likely to need a detailed knowledge of the individual standards. However, they should be able to read and understand the parts of the standards that are identified as relevant and ask challenging questions and probe the answers given by management and auditors. Most importantly, directors need to be comfortable with the answers to their questions given by their fellow directors, management, and the auditors.

Documents for review

There should be a number of documents produced leading up to the board's reviewing and approving a set of annual accounts. Some of these documents may be included in audit committee papers as well as board papers, and board members should have access, and the opportunity, to read all of these papers as part of their routine work preparing for a board meeting. The documents should include:

- draft accounts with notes,
- going concern and viability review,

- draft letter of representations required by the auditors from the board,
- accounting papers produced by the executive addressing areas of judgement on selecting and applying accounting policies,
- accounting papers produced by the executive addressing economic assessments such as fair valuations, discounted liabilities, and asset impairment assessments,
- audit plan (including risk assessment), and
- auditor's letter report at the completion of their audit work.

Risk disclosures

Risk disclosures have been a hot topic amongst accounting standard setters and capital market regulators. Whilst specific disclosure requirements may vary by jurisdiction, the annual report should contain the board's assessment of significant financial risks, and the accounts should contain details about the financial market and other financial risks to which the entity is exposed.

Directors will want to review these disclosures and be satisfied that they reflect what worried the board during the year about its finances and its financial reporting.

Whilst some claim that accounting has become overly complicated since IFRS was introduced (so external reporting is different to management accounting), don't be seduced into assuming that's true for your entity. The reality is that for most businesses, what gets reported externally in the accounts should be the same as what gets reported in the monthly management accounts. If you don't recognise the draft profit or loss, ask for a reconciliation comparing the two and for an explanation of the difference.

Eliminating bias

Accounting is designed to portray the results and financial position of the entity concerns in a neutral way, and if there is any bias it should reflect a degree of caution in making estimates and judgements.

Accounting standards are increasingly codifying how transactions and balances should be recorded and measured, but there is often scope to choose from a range of acceptable policies and it's important to know whether in aggregate those choices are neutral, aggressive, or prudent. Ask for a view from the experienced financial professionals. If management

feels unable to guide you on whether accounting policies are neutral or not, why not ask for a view from the auditors?

Materiality

The concept of materiality underpins the disclosures required to be made to help shareholders and other stakeholders understand your financial results and financial position. Broadly, something is material if knowledge of it would have an impact on decisions made by shareholders or potential investors.

Generally, materiality is expressed in terms of a small percentage of net profit or net assets. However, accounting standards also explain that something might be material due to its nature rather than just its absolute size. Ask management what is seen as material. The auditors should have explained how they assess materiality in their work in their annual audit planning document.

You may be a director of a simple entity with simple accounting. However, almost all businesses undertake more complex transactions from time to time, and it must be expected that accounting for more complex transactions brings its own challenges. IFRS and other accounting standards require an explanation to be given of significant judgements made when selecting and applying accounting policies. Read the disclosures and make sure you understand the issues described.

Accounting policies

Each significant judgement about the selection and application of accounting policies should be supported by an accounting paper prepared by the executive. Ask for a copy and ask for the chairman of the audit committee to talk you through them. Do any of them seem overly complex and contrived. If so, ask what the alternative accounting policy could be. If the alternative looks simpler, it may be a better one.

Accounting standards and their interpretation do change with time, as does the precise nature of contractual relationships between an entity and its customers, suppliers, and employees. As a result, accounting policy decisions should be revisited regularly. Do not be put off by comments such

as “we decided that many years ago,” “the papers are in the archive,” or “nothing has changed recently.”

Some entities appear to have a plethora of accounting policies, many of which are “boiler plate” – text plucked out of the accounting standard. It may be useful to step back and reflect on the policies that are most critical to how profit, and thus the result for the year, is measured.

For many entities, revenue recognition will be the accounting policy that has the most profound effect on reported results, particularly where revenue is generated through a number of service steps. For others, cost recognition can be as important, particularly where costs are incurred well in advance of the provision of services.

Difficult measurement judgements, fair value estimates, and impairment tests

IFRS and other accounting standards have developed with an increased focus on current economics – what things were worth and what you owed, based on the specific conditions in existence at the balance sheet date. That may impact on assets that you must fair value such as stocks and shares and assets that you must test for impairment, such as goodwill and intangible assets. Accounting standards require the assumptions and evidence supporting difficult measurement judgements to be explained in the notes.

Valuing listed stocks and shares should not be difficult as market prices can be obtained quickly. However, models may need to be used to estimate the fair value of assets where active markets do not exist. The measurement objective is to estimate what you could sell them for at the balance sheet date and external inputs should be used for valuation models whenever available. If significant assets are fair valued, you may wish to read the papers on how the valuations have been carried out, taking a special interest in any assumptions.

Impairment tests require future cash flows to be estimated and then the net cash flows to be discounted at the discount rate that would be applied by a potential purchaser of the asset. Note this is not the discount rate that the business might use itself. Directors will have access to cash flow forecasts for at least the next 12 months, which you would expect to be consistent with any impairment test estimates. If the subsequent cash flows

show a hockey stick profile, you may wish to ask more questions about how credible those forecasts may be.

Undisclosed commitments and contingencies

Accounting systems struggle to capture commitments and contingencies and as such, future events don't immediately give rise to double-entry booking. It's worth taking a moment to compare what is reported in the notes as commitments and contingencies with your knowledge of the business and to check whether they should be added.

Events after the balance sheet date could give rise to information about assets and liabilities at the balance sheet date where the accounts should be adjusted, or to material matters about the period post the year end but before the date of approval by the board. If the board has been discussing a significant issue in recent weeks, check whether it should be disclosed.

Auditors

Auditors collect the information and explanations that they require in order to form their opinion. Where they find something difficult to verify from independent sources, they may request that the board provide written representations, particularly if the audit evidence has been heavily dependent on representations made by management. The representation letter requested by the auditors should be carefully reviewed and questions may usefully be asked if there is anything unusual.

Governance codes and securities law and regulation vary according to jurisdiction. In most jurisdictions, directors are required to produce accounts that give a true and fair view that presents the results for the year and the financial position of the entity. In some jurisdictions, directors are required to confirm that annual accounts within the context of annual reports are fair, balanced, and understandable.

Once you have read the accounts and explanations as part of the annual report, sit back and consider whether all of the difficult issues discussed by the board in recent months have been properly addressed. If something has not been disclosed, ask why not. If the results don't make sense when compared to what you know about the entity and its transactions, don't stop asking questions until you are content.

Questions to ask

- Do you understand the accounts and accounting policies as well as your responsibilities for the accounts as director of the entity?
- Do you appreciate the accounting standards, laws, and regulations that apply to the entity?
- Do you need to have read and understood all the accounting standards?
- Have you read all of the documents available to you when considering the annual accounts?
- Have you considered and probed the draft financial risk assessments, and do they cover all the accounting matters that the board has spent significant time on in recent months?
- Are the draft annual or interim results similar to the management accounts that you have seen?
- Are the chosen accounting policies neutral or aggressive or cautious?
- Have you thought about what's material to shareholders?
- Have you reviewed and probed the draft disclosures about significant judgements made in selecting and applying accounting policies?
- Have you asked for and read the papers supporting accounting policy choices?
- Have you thought about which accounting policies are the most critical?
- Have you reviewed and probed the draft disclosures about significant measurement matters?
- Are you happy with the assumptions used to estimate fair values?
- Are you happy with the assumptions used in any impairment tests?
- Are you aware of any significant commitments or contingencies not disclosed?
- Have you considered whether all significant subsequent events have been disclosed?
- Have you read what written representations that auditors are asking the board to make – and are you happy to stand behind them?
- Are the draft accounts within the annual report true and fair/presented fairly and is the narrative fair, balanced, and understandable?
- Are there any remaining niggles?