Learn to Live with Risk

[4.11] All organisations face risks. For businesses taking risks is there very reason for being for profit is the reward for taking a risk. Every in-house counsel I have spoken with talks about risk, how they manage it and how it impacts their organisation.

We can all understand risk in theory, but learning to live with it is a different matter. As an in-house lawyer you will be asked constantly about the risk of something occurring and the impact of it on your organisation. You can give a legalistic answer (e.g. that it is reasonably foreseeable) but that will not help your organisation very much. Instead you need to embrace the risks for your organisation by understanding them and how the organisation as a whole manages them. Whilst there are some risks that we will all try to eradicate (I would hope that all organisations strive to ensure that their employees return home safely to their family and friends at the end of their work) there are others which may acceptable for us to take, provided that we know how to manage them.

In Chapter 9 we will look in more detail at risk and how it affects our work. That will give you some feel for the ways in which you can analyse it. However, there is a difference between analysis and embracing risk. The latter can only be done by playing your full role in the organisation, not just as a lawyer, but as a manager who uses their legal skills to manage the business.

Conclusion

[4.12] I have selected these ten themes because in interviewing many people in the in-house world, these were the most recurrent. There may be many more tips that you pick up along the way and some that you yourself will hand on to others.

If you are detecting a common theme, it is likely to be that there are very few barriers between you and others in the organisation. You probably welcome in-house was to be 'closer to the business'. Be careful not to re-erect the barriers between you and your business colleagues. Act as your business colleagues act when conducting business with each other. Be accessible and feel free to dress down if that is the accepted norm and above all talk and write to people in everyday English (we will look at communication skills later in the book). Above all, become part of the culture. This is not to say you should surrender your principles or ethics, merely that you should not put obstacles based on professional qualification between you and your colleagues. The only situation in which an in-house lawyer knows best is when commenting on the legal aspects of a problem. Otherwise, have a view, express it, but never try to use the fact that you are a lawyer to suggest that you know better than others in the room.

Armed with these pointers towards a successful career, we can now begin to look at the detail that will underpin that success.

Chapter 5

The In-house Lawyer as Legal Adviser – Professional Integrity

Introduction

[5.1] Professional integrity, to those of us who are lawyers, is the bedrock of all our responsibilities to our client. To most other people their lawyer's integrity is at the top of the list of important professional qualities. They would hope that their lawyer would act with candour and in their best interests at all times. Indeed, in business, they sometimes talk about the lawyers 'keeping them honest'.

In matters of law '[a] lawyer is to do for his client all that his client might fairly do for himself, if he could' – so wrote Dr Johnson. Our duty goes beyond following instructions. Instead we are there to map out the way in which our clients can best help themselves. We must do so by acting at all times in the best interest of our clients. It is the obligation of professional integrity which puts the onus on us to do all that we can, lawfully, to best represent our client's interests.

The aim of this chapter is to look more closely at the meaning of professional integrity for in-house lawyers and to consider how we should go about ensuring that we preserve it. To do this we will look at some fundamental issues. What does professional integrity cover? Who is our client? How far are we allowed to go in our client's interests? These questions can arise in varying degrees on an alarmingly regular basis, even if the most extreme cases are rare.

Professional integrity encompasses four elements:

- A duty not to abuse your relationship with your employing organisation – 'Trust and Confidence';
- A duty to be independent;
- A responsibility to properly manage conflicts of interest;
- An obligation to conduct relations with third parties with propriety.

These duties and obligations are, of course, the same for in-house lawyers and those in private practice alike. However, the situations in which the issues arise are different for those in-house. Indeed, the in-house lawyer has to manage the most obvious and deep rooted conflict of all – the conflict between the employer and the in-house lawyer. We will consider all this below.

Who is my Client?

[5.2] In private practice it is fairly easy to establish who the client is. They are usually sitting in front of you and have the obligation to pay your bill. Their name goes on the front of the file and there is a client account ledger set up in their name.

As in-house lawyers we have none of these clues to help us. The waters are further muddied by the fact that usually anyone in your organisation can approach you for assistance. On top of trying to understand whether or not they have authority to give you instructions, you also need to work out the motive for those instructions. Are they doing it because it is genuinely in the best interests of the organisation or do they have some ulterior motive such as their bonus or to win an internal political battle? You have to be alive to all of those questions.

You could go down the route of legalistically working out who is your client. For employed barristers, the Employed Barristers Code is quite clear; it is the employer who is the client for the purposes of the code. For solicitors, you get told in Rule 4 of the Solicitors Regulation Authority Practice Framework Rules who you can act for. Rule 4.1 states that 'You must not act for a client other than your employer . . . ' This is consistent throughout Rule 4 although there are some limited exceptions. This would also cover, for example, a situation whereby the in-house lawyer is employed by a service company being wholly owned by a parent company. The solicitor could then treat the holding company as his or her client – see Rule 4.7 which covers all related bodies. Beyond that, unless the in-house solicitor can bring the potential client into one of the other exceptions under Rule 13 (eg Pro Bono or Charities) then the in-house lawyer is restricted and not permitted to act.

For local authorities, the rules become more complex. The rules for local government lawyers empower them to act for other organisations in respect of which their authority has statutory authority to provide legal services – see Rule 13.08. These services can be provided to other public bodies at a profit – see the Local Authorities (Goods and Services) Act 1970 s 1(b). These powers were extended by s 93 of the Local Government Act 2003 to other organisations albeit for a charge equal to cost.

Consequently, authorities such as Kent County Council can now count other councils, schools, the Courts Service and the Association of Police Officers as clients of their legal department (https://shareweb.kent.gov.uk/Documents/business/legal-and-democracy/articles/external%20clients0001.pdf). With the introduction of the operative provisions over the next few years of the Legal Services Act 2007, the possibility of client lists for in-house teams increases. So, therefore, does the importance of the rules on conflicts of interest.

However, even though the lawyer may be permitted to provide legal services to the 'employer' and others, this still does not answer the question as to who actually provides the instructions to the in-house lawyer and therefore for practical purposes is 'the client'.

In a company, it is the company which is your client, but the company is an artificial legal construct, which can only act through its human agents – the Board of Directors. In a small organisation, you may interact with the directors all the time. However, if you are in a large organisation, you may rarely, if ever, meet a main board director. In large corporate organisations, many lawyers operate at on a day to day basis with people with alarmingly important titles such as 'Director of . . . ', 'President', 'Head of . . . ' or 'Chief'. Indeed, if the organisation is global, the problem can be compounded by the introduction of the prefixes 'Global', 'International' or 'Worldwide'. Some of those people may have very big titles, but an inverse amount of authority to commit

the company to any decision. I used to have a starting point; the longer the title, the less important they were likely to be. I can say this because, for a while, I had the title 'Head of the Assets and Real Estate Legal Team'. If you have an organisation directory, look them up and find out where they sit in the corporate firmament. Above all, do not fall for the fact that they have a big and important sounding title that they have authority to bind the organisation to anything important. They often do not.

The key question for you as an in-house lawyer, what ever the type of organisation you sit in is 'does this person have the authority to give me instructions on behalf of the organisation?' There are a number of places where formal authority can be found:

- ***The constitution of the organisation*** – articles of association, trust deed, partnership deed;
- ***Resolutions of the Members*** – Shareholders' or members' resolutions given in General Meetings;
- ***Resolutions of the Governing Body*** – either orders or resolutions. These can either be standing orders or reserved powers which provide for ongoing authorities or orders or resolutions which may be given to people to carry out specific tasks;
- ***Statutory Authority*** – under statutes such as the Companies Acts, the Charities Act, the Partnership Acts, Local Government legislation and all subordinate legislation.

[5.3] You can also ask the person concerned what authority they have for a course of action. When you do, try to avoid sounding accusatorial or patronising about it. More often than not, they may not have realised that they need authority to do a particular thing. Remember you are trying to help them achieve the legitimate aims of your organisation.

In a fast moving environment, it can sometimes be difficult to establish the chain of authority. Furthermore, you may not be thanked for it by busy people who have a job to do. Handling questions of authority can sometimes be difficult because of personalities. You must approach it diplomatically. Be aware, when you raise an issue of authority, the person with whom you have raised the question with may well take it as a personal affront, allied to a loss of face. Give them room to fully express their views, but work to help them understand the need for proper authority.

In the final analysis, it is your role to ensure that the organisation is acting lawfully. This is a question of judgement and, as we will see below in the section on independence, there are a number of ways that people use (consciously or subconsciously) to duck the issue. When I was faced by a difficult situation, I always went back to the same question 'Can I justify this action to my peers and the shareholders?

Case Study – A Matter of Finance

Alnic has recently agreed, subject to contract, to purchase a new computer system for £12m that will link its offices across Europe and North America. Kate in the procurement team has been finalising the legal documents on behalf of Alnic's procurement function. The docu-

ments are ready to be signed. The General Manager says he has authority to sign the deal. He does not want to bother the CFO with the deal as the CFO is too busy and has already approved it in principle. What should Kate do?

Kate needs to check the relevant authorities that are required to approve the deal. She knows that the CFO holds a reserved power from the Board to approve any capital expenditure up to £20m. Therefore a Board Approval is not necessary. The General Manager cannot produce any documentary evidence to support his assertion that the CFO has approved the deal in principle. She agrees with the General Manager that a short briefing paper will be sent to the CFO which she and the General manager will co-produce, setting out the material points and seeking formal approval of the deal as well as confirmation that the General manager may sign it provided that there are no changes to the material terms set out in the paper.

Independence

[5.4] 'So and so is a real company person, through and through', we often hear. In some circumstances it may be commendable, but when it becomes single minded loyalty, we as in-house lawyers need to observe our duty of independence.

When you are trying to give your all for the organisation, retaining your independence can be the hardest thing that you can do. People go in-house so that they can be part of the business or organisation they work for. The very reason many leave private practice is to pull down the barrier between themselves and the client. When you arrive in-house, you want to succeed. In the opening years of the twenty first century success is often measured by getting things done, not by stopping things from happening. Yet the time you have to assert independence most often is when you have to stop things in their tracks.

The paramount and enduring conflict for an in-house lawyer is that between themselves and their employer. In the most serious of cases that could result in you having to make a decision that results in your resignation. No wonder in-house lawyers feel that conflict. To unravel it and look at how we can manage it, we first need to understand why an in-house lawyer may consciously or sub-consciously be reluctant to assert their authority.

Not being 'One of the us'

[5.5] There is nothing more difficult, if you are trying to be accepted by an organisation, than to put your foot down and say that you cannot advise them to proceed on the basis put to you. In many instances you will be accused of being a 'deal-stopper' and at worst, disloyal to the organisation. Even if it is acknowledged you are right, there will be disappointment because it may result in many months of work by a project team being lost because the lawyer said 'No'.

If you are exercising your judgement after proper consideration of the situation and that is your genuine belief that you have to stop something from happening, then you must stick to it. However you must also be prepared to

explain it. You must be sympathetic to the business team you are advising. They will undoubtedly have expended considerable effort (and probably money) on their work to date. Furthermore you should not underestimate the amount of personal emotional capital that will have been invested in the work by individuals. They may also feel they are losing face with their managers for not having spotted the legal problems or at least spoken to you earlier. However never say 'yes' just because you are told that you are a deal stopper or that you might cause disappointment. The organisation, your client, expects more than that.

Do not just send an e-mail telling the business people they cannot do it. Instead, as a first step, go to see them and discuss the situation. Check that they have expressed what they are doing correctly and that you have properly understood them. Explore with them alternatives and above all, understand the risks. Remember, you may well need to work with them again in future.

This decision is above my pay grade

[5.6] It is an immutable proposition that most people like to upwardly delegate difficult issues. 'I am not paid to understand this issue or make any decision on it', they say. Many years ago, when I was training, I used to attend the Queens Bench Division on Masters Summons. On one occasion, I had picked up the file from one of the litigation solicitors. A brief note of instruction was attached including the entreaty 'Do not forget to ask for our costs'. During the hearing the Master asked me a question I could not answer. In a panic I uttered the words 'This is not my file, Master'. I cannot describe the colour that he went. The Master asked in a manner so splenetic that I thought he might have a stroke 'What do you mean it is not your file? You are holding it, young man!' He was right. At that moment, I was representing my client. At that moment, the buck stopped with me.

If you have control of the 'file', it is not 'above your pay grade'. If you are the lawyer in the room, you must exercise your independence and give your advice. It may be that you want to take the matter up with somebody more senior, but at that moment, you must advise in an objective manner, to the best of your ability. For an in-house lawyer, there is no equivalent of going to get the partner in charge.

If the matter is one on which you feel you need time, say so. Do not find yourself bullied into giving an answer that suits the other people. If there is genuinely no time, take the action that you think is right. It may be an old adage, but it is still true, that in most cases a decision, even if it is wrong, it is generally better than you making no decision at all, as the business people will lose confidence in you and in future take matters out of your hands.

On second thoughts, it looks all right

[5.7] Of the three reasons to avoid conflict, this is the most difficult for it can be quite easy to convince yourself that actually there is not a problem after all. This particular reason is usually coupled with the supplementary comment that 'It must be all right. After all, they are much more experienced than I am'.

Never assume. Wisdom and experience do not always walk hand in hand.

27, may no longer enthuse you later in life. May be you want to switch from profit to not for profit organisations? You may want other life experiences. Leaving your existing role voluntarily can be a huge step. However it can also be massively rewarding.

Sometimes career breaks are not voluntary, such as redundancy, which can be devastating as it is not just a loss of income, but a loss of personal stature. It will tax your reserves of personality. Try to stay positive and to use the opportunity to fill some of your skills gaps. Study if you can whilst trying to find a new job. Alternatively try to do some voluntary work. Try not to become de-skilled. For example look at offering pro bono legal advice. For an example see http://www.nationalprobonocentre.org.uk/. Do everything you can to make a very negative experience yield positives. Above all, never lose your esteem. It may seem like a lifetime at the time, but in the context of thirty or forty years, it is very short.

Moving Roles

[16.12] One of the benefits of being in-house is that there are fewer hang-ups about people moving jobs. In private practice, I recall people being mortified when I said I wanted to move to another company as they took it as a lack of loyalty and a personal affront. When somebody left my teams to develop their career, it was always tinged with sadness for me that I was losing somebody good, but that was mixed with a sense of pride and pleasure that that person was on to the next stage of their career.

How often should you move jobs? As always there is no uniform answer. I think it depends on you and what you feel is right. As a general rule of thumb, I would recommend you reassess your role every three years. In big organisations, particularly in the senior echelons (and do not forget that even as a junior lawyer you may be relatively senior in the organisation) many executives move every 3 to 5 years.

Another thing to recognise is that organisations change culturally. What may have been the culture when you joined may be very different to the culture today. In that regard, you may find the skills and values that you have are not those currently required by your organisation. Alternatively, you may have outgrown the organisation. Should you leave the organisation or re-skill yourself? Keep it all under review. Developing your career is a task that requires constant maintenance.

And finally . . .

[16.13] However dedicated you are to your career, it is only a job. Make sure that you get as much pleasure from it as you can, but remember it should not be the sole source of pleasure for you.

Chapter 17

Accounts and Audit

Introduction

[17.1] Earlier in the book, I identified one of the key skills for an in-house lawyer to have is an understanding of accounting. Although I am not particularly numerate, being able to understand some of the basics of the finances and accounts gives me a valuable insight into the organisation. It allows me to understand a lot more of what my business colleagues are saying and how they view the financial challenges ahead.

By understanding the accounts of an organisation, you will be able to play a far deeper role in it. Furthermore, an understanding of various ratios and other metrics will give you early warnings if your organisation is running into choppy financial waters. That skill could prove vital when advising the directors and senior management.

I am grateful to Glynis Morris for providing this important chapter.

Statutory accounts

[17.2] In-house lawyers may come across two types of company accounts:

- *statutory accounts* (sometimes referred to as financial accounts or annual accounts) – these must be formally approved by the directors and delivered to the registrar each year (and in the case of a parent company they may need to include group accounts – see para **17.32** below);
- *management accounts* – these are prepared on a regular basis throughout the year to help directors and other senior managers to monitor business performance (see para **17.45** below).

Most companies have the option of preparing their statutory accounts as:

- Companies Act accounts – by following the detailed requirements of company law and UK accounting practice; or
- IAS accounts – by following the detailed requirements of international accounting standards and giving certain additional disclosures.

Listed companies and those with shares traded on the Alternative Investment Market (AIM) must always prepare IAS group accounts. By contrast, charitable companies must always prepare Companies Act individual and/or group accounts.

Most other companies adopt UK accounting practice and so prepare Companies Act accounts. Those most likely to prepare IAS accounts on a voluntary basis are:

- stand-alone listed and AIM companies – so that they are more comparable with listed and AIM groups; and
- subsidiaries of a parent company that prepares IAS group accounts – to avoid the need to prepare figures on two different bases each year.

A decision to prepare IAS accounts can generally only be reversed in specific circumstance, although for periods ending on or after 1 October 2012 a company that prepares IAS accounts has more flexibility to change to UK accounting practice no more than once every five years[1].

[1] CA 2006, s 395(4A), inserted by SI 2012/2301.

Small companies

[17.3] There is a separate accounts regime for companies that qualify as small (qualification as a small company is dealt with in CA 2006, ss 382 and 383). This allows them to:

- reduce the detailed information given in their annual accounts; and
- deliver abbreviated accounts to the registrar.

However, certain types of company are excluded from the small companies regime, even though they meet the normal qualifying conditions; details of those excluded from the small companies regime can be found in CA 2006, s 384.

Accounting records

[17.4] Directors must maintain accounting records[1] that are sufficient to:

- show and explain the company's transactions;
- disclose the company's financial position with reasonable accuracy at any point in time; and
- enable them to prepare accounts that comply with the legislation.

[1] Requirements on accounting records can be found in CA 2006, ss 386 to 388. The Institute of Chartered Accountants in England and Wales has published detailed guidance in TECH 01/11 '*Guidance for directors on accounting records under the Companies Act 2006*'.

Non-corporate entities

[17.5] Limited liability partnerships (LLPs) are subject to the same accounts requirements as companies, and other legislation imposes similar requirements on specialised entities such as charities and pension funds.

Other unincorporated businesses (eg partnerships and sole traders) still need to prepare suitable accounts each year for tax purposes but are generally not subject to detailed legislative or other accounting requirements.

True and fair view

[17.6] Directors must not approve statutory accounts unless they are satisfied that those accounts give a true and fair view of the assets, liabilities, financial position and profit or loss of the company or group. This applies to both Companies Act and IAS accounts.

The most recent authoritative statement on the true and fair view is the Opinion by Martin Moore QC[1]. A report issued jointly by the Accounting Standards Board (ASB) and Auditing Practices Board (APB) in July 2011[2] also confirms the continuing importance of the true and fair view. There is no precise definition of what constitutes a true and fair view. Interpretations vary as accounting practice develops and new accounting standards are introduced (often to deal with changes in business practices or to respond to economic developments). As a result, an accounting treatment that was considered to achieve a true and fair view several years ago will not necessarily do so today.

In the case of Companies Act accounts:

- additional information must be given where necessary to achieve a true and fair view;
- the directors must depart from the detailed requirements of company law if this is necessary to achieve a true and fair view – this is commonly referred to the 'true and fair override' and additional disclosures must be given in the accounts when it is applied.

In the case of IAS accounts:

- accounting standards require the accounts to 'present fairly' the financial position, financial performance and cash flows of the entity;
- the true and fair override does not apply, but departure from strict compliance with an accounting standard is permitted where necessary to achieve a fair presentation (subject to additional disclosures) – this is expected to be rare in practice.

[1] '*The true and fair requirement revisited*', available at http://www.frc.org.uk/FRC-Documents/FRC/True-and-Fair-Opinion,-Moore,-21-April-2008.aspx.

[2] '*True and Fair*', available at http://www.frc.org.uk/FRC-Documents/FRC/Paper-True-and-Fair.aspx.

Accounting standards

[17.7] Accounting standards have statutory recognition and any non-compliance with them must be disclosed. Consequently, it is usually accepted that accounts must comply with all relevant accounting standards in order to show a true and fair view and that any departure must be explained and justified in the accounts.

Accounting standards are developed and issued as follows:

- from July 2012, the Financial Reporting Council (FRC) is responsible for UK accounting standards (prior to this, they were issued by the Accounting Standards Board (ASB)) – these are now issued as Financial Reporting Standards (FRS) and were previously issued as Statements of Standard Accounting Practice (SSAP);
- the International Accounting Standards Board (IASB) is responsible for international accounting standards – these are now issued as International Financial Reporting Standards (IFRS) and were previously issued as International Accounting Standards (IAS).

For practical purposes, FRS and SSAP have equivalent status under UK accounting practice, as do IFRS and IAS internationally.

Abstracts and Interpretations

[17.8] The FRC issues Abstracts (until July 2012, these were issued by the Urgent Issues Task Force (UITF)) and the International Financial Reporting Interpretations Committee (IFRIC) issues Interpretations, to deal with issues that are covered in accounting standards but have been identified as causing difficulty or giving rise to different interpretations in practice. These documents have the same status as accounting standards.

Future UK accounting practice

[17.9] The FRC is currently taking forward a project initiated by the ASB to converge UK accounting practice with international requirements. The latest detailed proposals were published in January 2012 and include a new 'Financial Reporting Standard applicable in the UK and Republic of Ireland' (draft FRS 102) that is intended to replace all current UK accounting standards[1]. They also include a reduced disclosure regime for subsidiaries and parent companies in respect of their own individual accounts, but not in respect of any consolidated accounts.

Entities that qualify as small will continue to have the option of adopting the Financial Reporting Standard for Smaller Entities (FRSSE) in place of the new standard. However, the present FRSSE will also need significant revision in light of the EC proposals for a new Accounting Directive which would reduce the amount of financial information that small companies need to report and prohibit Member States from imposing additional requirements.

The new FRS 102 is expected to apply for accounting periods beginning on or after 1 January 2015, although earlier adoption is also likely to be permitted. The FRC has indicated that it hopes to make the reduced disclosure regime available to parents and subsidiaries for accounting periods ending on or after 31 December 2012.

[1] Full details of the project can be found at http://www.frc.org.uk/Our-Work/Codes-Standards/Accounting-and-Reporting-Policy/The-future-of-UK-GAAP.aspx.

FRC Conduct Committee

[17.10] The FRC Conduct Committee enquires into annual reports and accounts that do not appear to comply with relevant requirements. It has wide powers to require additional information from directors and to apply to the courts for an order requiring the revision of defective accounts and reports. Prior to July 2012, this review work was undertaken by the Financial Reporting Review Panel (FRRP).

Accounting principles

[17.11] Accounting practice is based on a number of fundamental principles. These are set out in detail in the FRC's 'Statement of Principles for Financial Reporting' and the IASB's 'Framework for the Preparation and Presentation of Financial Statements'.

Going concern

[17.12] Accounts should be prepared on the basis that the business is a going concern (ie that it can continue in operational existence for the foreseeable future) unless the company is being liquidated or has ceased trading, or the directors have no realistic alternative but to liquidate the company or to cease trading. Directors must assess, when the statutory accounts are formally approved, whether there are any significant doubts about the company's ability to continue as a going concern, taking into account all available information. The detailed procedures to be undertaken will vary depending on the size, complexity and circumstances of each business[1].

The directors of listed companies must make a formal statement on going concern in the annual report and accounts, and all companies must disclose any material uncertainties that could cast significant doubt on the ability of the company to continue as a going concern.

[1] Detailed guidance on the assessment of going concern, the review period, and going concern disclosures is set out in '*Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009*' published by the Financial Reporting Council (available at http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/Going-concern-and-financial-reporting.aspx.).

Accruals

[17.13] All income, profits, expenses and losses relating to a financial year must be included in the accounts for that year, regardless of the actual date of receipt or payment. However, the need for prudence may also be relevant (see para 17.15 below).

Consistency and comparability

[17.14] Accounting policies provide a framework for the way in which assets, liabilities, income and expenses are recognised, measured and presented in annual accounts. They must be applied consistently within an accounting period and from year to year, and figures for the previous financial year must be adjusted where necessary so that they are presented on a comparable basis.

There will inevitably be occasions when an accounting policy needs to be changed – for instance, where a change to accounting standards requires a different treatment or where the nature or scale of an activity changes so that an existing accounting policy is no longer appropriate. Specific accounting and disclosure requirements apply whenever an accounting policy is changed.

Prudence

[17.15] Both the ASB and the IASB define prudence as:

> The inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that gains or assets are not overstated and losses and liabilities are not understated.

Where appropriate, accounting policies should take account of uncertainty in recognising and measuring items for inclusion in the accounts, but prudence should not be needed if there is no uncertainty.

Accounting standards are also clear that prudence should not be used to justify:

- the deliberate understatement of assets or gains, or overstatement of liabilities or losses;
- the creation of excessive provisions or hidden reserves.

Substance over form

[17.16] Accounts must reflect the commercial substance of transactions rather than their legal form (if different). It is not always easy to identify the commercial substance of a transaction, especially where:

- the main benefits of an asset are separated in some way from legal ownership;
- a transaction involves options and conditions that are not commercially realistic; or
- the overall commercial impact of a series of transactions differs from the apparent effect of the individual transactions.

Also, if a company has been party to any arrangements that are not recognised in the balance sheet and which give rise to material risks or benefits at the balance sheet date, the nature and business purpose of the arrangements, and their financial impact on the company, must be disclosed in the accounts.

These requirements are intended to help tackle the problem of off-balance sheet financing, where a company enters into complex financial arrangements designed to keep borrowings or other liabilities off its balance sheet.

Accounting rules

[17.17] In the case of Companies Act accounts, a company can adopt:

- the historical cost accounting rules; or
- the alternative accounting rules (although some of these conflict with UK accounting standards and so cannot be used in practice); or
- a combination of the two – for instance, it is common practice to adopt the alternative accounting rules for property so that it can be included in the balance sheet at valuation rather than cost, but otherwise to use historical cost accounting.

These accounting rules are not relevant where IAS accounts are prepared.

Fair value accounting can also be used for certain financial assets and financial liabilities. Under UK accounting practice, listed companies must adopt fair value accounting by applying the UK accounting standards that provide the relevant framework, but it is optional for other companies and few adopt it voluntarily. Fair value accounting is also required in IAS accounts.

Performance statements

[17.18] The profit and loss account is the main performance statement in Companies Act accounts and must follow one of four standard formats. Companies must also prepare a statement of total recognised gains and losses (STRGL) which draws together the result shown in the profit and loss account and any other gains and losses recognised directly in reserves. For instance, a STRGL might show:

	£000
Profit for the financial year	350
Unrealised surplus on revaluation of properties	24
Unrealised exchange differences on foreign currency net investments	(10)
Total gains and losses recognised since the last annual accounts	364

In IAS accounts, companies have the option of:

- presenting all income and expenses in a single statement of comprehensive income; or
- presenting a separate income statement (covering components of profit or loss) and a statement of comprehensive income, which shows the profit or loss for the year together with other gains and losses recognised in the year.

The second option gives a similar result to UK accounting practice.

In both cases, additional detail and analysis of the figures must be given in the notes to the accounts. Some of these disclosures are prescribed by law and others by accounting standards.

The key items likely to be shown in a profit and loss account or income statement are discussed briefly below.

Turnover (or revenue)

[17.19] Turnover (or revenue) represents income from the supply of goods and services to customers. This may sound straightforward but it can be a very complex area in practice, and the policies adopted in respect of revenue recognition and measurement can have a significant impact on the accounts. Different policies may be required for different income streams, and dealing with issues such as rebates, subsidies, incentives, extended warranties and rights of return can cause particular problems. The FRRP has frequently emphasised the need for clear disclosure of revenue recognition policies and in recent years has paid particular attention in its reviews to companies who appear to adopt more aggressive recognition policies than their peers.

Charges for depreciation, amortisation or impairment

[17.20] Fixed assets are intended for continuing use in the business and may be:

- tangible assets – such as property or equipment;
- intangible assets – such as licences, patents and purchased goodwill (see para 17.34); or
- long-term investments.

Tangible fixed assets must be depreciated, and intangible assets must be amortised systematically over their useful economic lives – in other words, over the period that the business expects to benefit from them. Depreciation (or amortisation) is therefore a way of measuring the economic benefits of an asset that have been consumed during the financial period.