The Story behind the Numbers: Examining an Annual Report

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Contents of an Annual Report

What’s usually in the Annual Report?

(1) Statements of Management

- *Chairman’s Statement* – This provides an overview of the company’s performance over the past trading year. It usually contains the strategy, financial performance and future prospects of the company.

- *Directors’ Report* – The principal objective of the Directors’ Report is to supplement the financial information with other information considered necessary for a full appreciation of the companies activities. The code of corporate governance provides detailed guidelines as to the contents of this report.

- *Balance Sheet/Statement of Financial Position* - A Balance Sheet is a statement of the resources owned and controlled by a business at a single point in time. It gives a snapshot of assets, liabilities and capital at a point in time.
What’s usually in the Annual Report? (contd.)

(1) Statements of Management (contd.)

- **Profit and Loss Account/Income Statement/Statement of Comprehensive Income** – The Profit and Loss (P&L) Account is a statement which shows total business revenue less expenses. The P&L account quantifies and explains the gains or losses of the company over the period of time bounded by two balance sheets.

- **Cash Flow Statement** – This is a statement which shows the flow of cash into and out of the business. The cash flow statement should not be confused with a cash flow forecast. The former is historical whereas the latter is a forecast about the future.

- **Statement of Changes in Equity** – This attempts to highlight all shareholder gains and losses and not just those from trading. For example, an upward revaluation of a fixed asset is not classed as revenue from trading operations and so it will not be included in the P&L account. It will be included as an addition to revaluation reserves on this statement.
What’s usually in the Annual Report? (contd.)

(1) Statements of Management (contd.)

- *Notes to the Financial Statements* - Provides a more detailed analysis of some of the entries in the accounts including:
  - Disclosure of accounting policies used (e.g. depreciation) and any changes to these policies.
  - Sources of turnover.
  - Details of fixed assets, investments, share capital, debentures and reserves.
  - Key management remuneration.
  - Earnings per share calculation (mainly for listed companies).

- Compliance with SEC code of corporate governance.
- Company statistical information.
Contents of an Annual Report (contd.)

What’s usually in the Annual Report? (contd.)

(2) Statement of Auditor

- Auditor’s Report – Opinion on truth and fairness of financial statements and compliance with relevant laws and accounting framework.
Financial Reporting Framework

- Listed company
  Financial statements have to comply with Companies Act 1994, Securities and Exchange Commission (SEC) regulations and Bangladesh Financial Reporting Standards (BFRSs) requirements.

- Bangladesh Financial Reporting Standards (BFRSs)
  BFRSs are the adopted versions of International Financial Reporting Standards by the Institute of Chartered Accountants of Bangladesh (ICAB).

- Conflicts
  Unfortunately, BFRS and Companies Act 1994 do not always agree; similarly BFRS and Bank Companies Act 1991 do not always agree.
Who is the Auditor?

- It is widely believed audit quality between firms in Bangladesh varies to an unacceptable degree.

- Firms affiliated to “Big 4” (Ernst & Young, Deloitte & Touche, KPMG and PricewaterhouseCoopers) should be more reliable than others.

- Firms whose affiliation is at a Member Firm level are however closely monitored by IHQ on matters of work quality, independence, etc.

- In Bangladesh, most shareholders at public AGMs ask to reduce audit fees, not realising a good auditor means better control over management’s reporting of financial information.
Things to look out for!! (contd.)

Audit Qualification

- The auditors' standard report states that the examination was performed in conformity with generally accepted auditing standards and by expressing an opinion that the client's financial statements are presented fairly in conformity with generally accepted accounting principles and other regulatory requirements.

- If there are deficiencies in the client's financial statements or limitations in the auditors' examination, or if there are other unusual conditions about which the readers of the financial statements should be informed, auditors' modify their report to make these problems or conditions known to users of the audited financial statements.
Things to look out for!! (contd.)

Audit Qualification (contd.)

- It is very important for the user’s of the accounts to read the auditor’s report in conjunction with the financial statements.

- For example, if the financial statements of a company shows the net profit after tax was BDT 10 million and the audit opinion discloses that an expense was understated by BDT 2 million and hence the profit was overstated by the same amount, actual profit is BDT 8 million, not BDT 10 million.
Consolidated Financial Statements

- Consolidated Financial Statements are financial statements where transactions and balances between parent company and subsidiary company are eliminated to show transactions outside the group only. Doing so typically requires a complex set of eliminating and consolidating entries to work back from individual financial statements to a group financial statement that is an accurate representation of operations.

A simplified example may be as follows:

<table>
<thead>
<tr>
<th></th>
<th>Parent company</th>
<th>Subsidiary company</th>
<th>Simple aggregate</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales – 3rd party</td>
<td>100</td>
<td>700</td>
<td>800</td>
<td>800</td>
</tr>
<tr>
<td>Sales – Inter-group</td>
<td>500</td>
<td>-</td>
<td>500</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total sales</strong></td>
<td><strong>600</strong></td>
<td><strong>700</strong></td>
<td><strong>1,300</strong></td>
<td><strong>800</strong></td>
</tr>
<tr>
<td>Expenses</td>
<td>(300)</td>
<td>(600)</td>
<td>(900)</td>
<td>(400)</td>
</tr>
<tr>
<td><strong>Profit</strong></td>
<td><strong>300</strong></td>
<td><strong>100</strong></td>
<td><strong>400</strong></td>
<td><strong>400</strong></td>
</tr>
</tbody>
</table>
Consolidated Financial Statements (contd.)

- Simple aggregation of sales for the holding company and subsidiary shows sales of 1300 for the group since it includes inter-group sales. Consolidation removes the effect of inter-company transactions and the balance of sales is 800 representing net sales to 3rd parties only. Although this will not have any impact on the profit for the group, the inflated sales figure may not be a true and fair representation of the holding company’s and group’s financial performance.

- Preparation of Consolidated Financial Statement is not a requirement under Companies Act 1994. The Act instructs individual financial statements to be prepared for each company. However, BFRS contradicts Companies Act 1994 in this respect and requires groups to prepare consolidated financial statements.
Asset Revaluation

- The revaluation of non-current assets is a common feature of contemporary accounting. If there is an increase in value of the asset because of revaluation this is credited to ‘Revaluation Reserve’. Revaluation may not always result in an increase in value.

- When a company revalues an asset, it must also revalue all similar assets. Once revaluation is carried out, a company is required to revalue the class of assets on a regular basis.

- Revaluation does not necessarily reveal an exact value of the asset. Revaluation is subjective as the revaluation amount reflects a mixture of the market price, asset quality, judgment of the valuer etc.

- Revaluation is not restricted to tangible fixed assets. Financial instruments are also revalued. However, that is a more complex process.
“Creating” Assets

- An item can be recognised as an asset only if it meets certain condition, e.g. whether income will follow from it.

- Companies pay penalties and want to show that as an asset.

- Companies want to recognise internally generated goodwill or brand value. Can only be recognised if paid for, provided income will flow from it, etc.
Things to look out for!! (contd.)

- Under/Over Provision
  - Not providing for bad or doubtful debt, tax liabilities, etc. is not uncommon.
  - This overstates value of the asset and profits of the company.
  - Management sometimes over provides in a good year and releases in a bad year. This is also wrong and is a form of “earnings management”.

Inappropriate Accounting Policy – *Disclosed in Notes*

- A company may disclose non-compliance with accounting standards in the notes to the accounts rather than auditors’ disclosing it in the Audit Opinion.

- Saying in the notes that it is the company’s policy not to depreciate certain assets, not to provide for gratuity, etc. does not make it right.

- The accounts are wrong and the auditor must qualify his opinion unless immaterial.
Inappropriate Accounting Policy – Sometimes very difficult to tell

- Companies A and B buy same capacity and make of plant each for BDT 100 million, and generate revenue of BDT 15 million each.
- A depreciates the plant over 10 years; B depreciates over 5 years.

- Results:

<table>
<thead>
<tr>
<th></th>
<th>Company A</th>
<th>Company B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(10)</td>
<td>(20)</td>
</tr>
<tr>
<td>Profit/(loss)</td>
<td>5</td>
<td>(5)</td>
</tr>
</tbody>
</table>
Related Party Transactions

- Bangladesh Accounting Standard (BAS) 24: *Related Party Disclosures* requires disclosure of related party transactions and outstanding balances in an entity’s financial statements. The standard provides detailed instruction on parties that should be considered as related.

- For example, a company may purchase goods from a firm which is owned by a director of the company. This information has to be disclosed in the financial statements of the company. The shareholders need to know the transactions carried out by the company particularly when the management in question has personal interest vested in such transaction. There is an incentive for the director to carry out the transaction to benefit his firm rather than acting in the interest of the company which appointed him/her as a director. Disclosures of such transaction allows the shareholder to be informed as well as evaluate the fairness of the transaction.
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