Audit briefings

What are financial accounts and what are they for?

1. Background

The future of audit is being debated in the UK[1] [2]. Whilst audit is not just an issue for what the government calls public interest entities (PIEs)[3], the focus of their concern is on such entities because they are the ones whose failure might cause greatest disruption within the economy, and loss to those involved with them.

The Corporate Accountability Network believes that audit does need reform within the UK[4]. However, it is our belief that the audit of a set of accounts or financial statements[5] cannot be considered as an issue that can be addressed independently of those accounts. It is our opinion that audited accounts are ultimately an inseparable whole. As such we suggest that the success or failure of auditing and accounting in meeting the needs of the users of those accounts cannot be separately appraised.

The question to ask in that case is, what are financial accounts? And, as important is the immediate follow-on question, which is what are those accounts for? We see the two as inseparable and so treat them as a single issue in this Audit Briefing. By doing so we come

[1] https://beisgovuk.citizenspace.com/business-frameworks/audit-and-corporate-governance-review/

[2] The consultation papers relating to this process are noted in the references noted at the end of this Briefing.

[3] The Corporate Accountability Network has issued a separate Audit Briefing on what it considers an appropriate definition of a PIE might be.

[4] See our separate Audit Briefing on the reasons why audit might need reform.

[5] We treat these terms interchangeably.

up with an answer that is very different to that offered by existing accounting and audit regulators[6].

That is unsurprising. We make a number of assumptions in this Audit Briefing that pre-ordain this outcome. Firstly, that is because we presume that financial statements[7] exist to meet the needs of their users, and not their producers. Second, we define those users of accounts much more widely than the accounting standards setters who currently prescribe the content of the accounts of PIEs[8]. Thirdly, we presume as a consequence that the content of those accounts will be somewhat different to those currently made available[9], somewhat reluctantly, to their current presumed users, who are invariably defined as 'investors' on the corporate website of those PIEs that issue these reports[10].

It is in this differing perception on this issue that we suggest that the misunderstandings on the true nature of audit failure lie[11]. If the true nature of the stakeholders of accounts was properly understood by those who regulate the production of accounts and their audit then we suggest that audited financial statements might not fail as often as they seem to do at present, by those regulators' own admission. That would, however, require that the true purpose of the accounts of a PIE be understood, which we suggest it is not at present. That is why the issues addressed by this Audit Briefing are so important[12].

2. What do we think the purpose of accounts to be?

Before discussing what regulators think the purpose of accounts to be, we think it is important that we state what our opinion is on this issue. We believe that accounts serve these purposes:

- To provide a report of the financial and other activities of any entity to those who might have a relevant interest in those activities;

[6] See references supplied to the thinking of the Financial Reporting Council, Department for Business, Energy and Industrial Strategy and International Financial Reporting Standards Foundation in the final section of this Audit Briefing.
[7] We use the terms accounts and financial statements interchangeably in this Audit Briefing.
[8] See our Audit Briefing on who the stakeholders of a PIE are.
[9] See our Audit Briefing on the information needs of the stakeholders of a PIE.
[10] If you wish to find the accounts of any PIE you invariably need to search the investor relations pages of its website. Whether by intention of otherwise they make clear who their priority in preparing these accounts is as a consequence.
[11] See our separate Audit Briefing on what audit failure might be considered to be.
[12] This briefing is based upon submissions made by Professors Richard Murphy and Adam Leaver of both Corporate Accountability Network and Sheffield University Management School to the BEIS consultation referenced in this Audit Briefing.

- To indicate the risks inherent within the activities of that reporting entity;
- To suggest whether that entity might continue to trade into the future;
- To provide opportunity for an independent third party, referred to as an auditor, to express an opinion upon the truth, fairness, or otherwise of the report prepared by the reporting entity for use by its stakeholders

This document is framed within that broad understanding.

There is one other assumption implicit in what we propose with regard to the accounting requirements of limited liability entities. Such concerns represent the vast majority of significant trading companies and other public interest entities (PIEs). The limited liability that shareholders enjoy means that they do not have to settle the debts of their companies if those companies become insolvent. Its creditors within society at large pick up that cost instead. That means that the shareholders of such entities are granted an extraordinary privilege by society. That privilege creates an obligation to account for its responsible use. It is our contention that this means that the full accounts of all limited liability entities must be available on public record so that all those stakeholders who might conceivably be impacted by the activities of that entity might be able to appraise the risk that they face because of them. It is on the basis of this logic that we make many of the suggestions included in this Audit Briefing and the other Audit Briefings in the series of which it is a part.

3. What do current accounting standards assume to be the purpose of accounts?

Two conflicting views on the purpose of financial statements are to be found in statements on this issue made by the accounting standards authorities whose requirements are commonly followed in the UK.

a. International Financial Reporting Standards

The International Financial Reporting Standard Foundation (IFRS) says in their Conceptual Framework[13] that the purpose of accounting is:

[13] https://www.ifrs.org/issued-standards/list-of-standards/conceptual-framework/

Objective, usefulness and limitations of general purpose financial reporting

1.2 The objective of general purpose financial reporting[1] is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity.[2] Those decisions involve decisions about:

(a) buying, selling or holding equity and debt instruments;

(b) providing or settling loans and other forms of credit; or

(c) exercising rights to vote on, or otherwise influence, management's actions that affect the use of the entity's economic resources.

1.3 The decisions described in paragraph 1.2 depend on the returns that existing and potential investors, lenders and other creditors expect, for example, dividends, principal and interest payments or market price increases. Investors', lenders' and other creditors' expectations about returns depend on their assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity and on their assessment of management's stewardship of the entity's economic resources. Existing and potential investors, lenders and other creditors need information to help them make those assessments.

1.4 To make the assessments described in paragraph 1.3, existing and potential investors, lenders and other creditors need information about:

(a) the economic resources of the entity, claims against the entity and changes in those resources and claims (see paragraphs 1.12–1.21); and

(b) how efficiently and effectively the entity's management and governing board[3] have discharged their responsibilities to use the entity's economic resources (see paragraphs 1.22–1.23).

IFRS standards are those most commonly used by public interest entities in the UK. It will be noted that:

- These standards are designed for use by a very limited user group, all of whom only have interest in the financial risk that they take when engaging with an entity;
- It is assumed that the financial statements have an investor orientation, which in turn assumes that the reporting entity is a limited liability corporate entity in which the investors have a vote, but PIEs may include other types of entity[14];
- It is assumed that the only question that a user of the financial statements might seek to answer using the data supplied is on whether or not they wish to make financial resources available to the PIE;

[14] See the Corporate Accountability Network Audit Briefing on the nature of a public interest entity (PIE).

- It is assumed that the equity and debt instruments of the entity preparing the financial accounts can be traded, but in the case of most companies this is not true, and it need not be the case amongst PIEs[15];

- It is assumed that no other interests in accounting data are of significance: para 1.10 of the IFRS Conceptual Framework, that follows the extract quoted above makes this clear by saying:

  > **1.10** **Other parties, such as regulators and members of the public other than investors, lenders and other creditors, may also find general purpose financial reports useful. However, those reports are not primarily directed to these other groups.**

  No reason for this assumption is given; it is simply presumed to be appropriate given the assumptions previously noted on the single identified use that might be made of financial statements;

- It is also assumed that financial statements produced by a PIE have no interest to its management:

  > **1.9** **The management of a reporting entity is also interested in financial information about the entity. However, management need not rely on general purpose financial reports because it is able to obtain the financial information it needs internally.**

  Again, no reason for this assumption is given; it is simply presumed to be appropriate without supporting evidence being given. It is very likely that this assumption is wrong. In many cases the information supplied by the financial statements might be new, or previously unfamiliar to members of the management of a PIE, or any other reporting entity, and in many organisations this might be the only occasion in a year when this data is produced. The accounting for tax included in the financial statements is, for example, data of this type.

- The assumptions noted in the two preceding paragraphs are made in support of this claim:

[15] There are roughly 4.7 million companies in the UK https://www.gov.uk/government/statistics/companies-register-activities-statistical-release-2020-to-2021/companies-register-activities-2020-to-2021
of which around 2,000 are quoted on a stock exchange https://www.statista.com/statistics/324547/uk-number-of-companies-lse/

> 1.12 General purpose financial reports provide information about the financial position of a reporting entity, which is information about the entity's economic resources and the claims against the reporting entity. Financial reports also provide information about the effects of transactions and other events that change a reporting entity's economic resources and claims. Both types of information provide useful input for decisions relating to providing resources to an entity.

What is made clear is that there is assumed to be a singular purpose for the data provided by financial statements and that any user or purpose not consistent with that assumption is considered of no interest within the framework for accounting that the International Financial Reporting Standard Foundation has sought to create whether that is appropriate or not.

- In this context it is appropriate to note this paragraph:

> 1.11 To a large extent, financial reports are based on estimates, judgements and models rather than exact depictions. The *Conceptual Framework* establishes the concepts that underlie those estimates, judgements and models. The concepts are the goal towards which the Board and preparers of financial reports strive. As with most goals, the *Conceptual Framework*'s vision of ideal financial reporting is unlikely to be achieved in full, at least not in the short term, because it takes time to understand, accept and implement new ways of analysing transactions and other events. Nevertheless, establishing a goal towards which to strive is essential if financial reporting is to evolve so as to improve its usefulness.

We emphasise this sentence:

> *To a large extent, financial reports are based on estimates, judgements and models rather than exact depictions.*

We do so to make clear that the accounting standards created by the International Financial Reporting Standards Foundation are just one model and that they are based on estimates and, most especially, judgements. Those judgements extend to the decision made as to whom those accounts are relevant, and as to what purpose they are intended to fulfil. Neither assumption is based on facts; nor are they necessarily right. The assumptions made are simply the expression of a view by one interest group. Others are entitled to a different opinion. Very different forms of accounting might result from different assumptions being made. The alternative assumptions that might be made and the nature of the resulting accounts is at the heart of the work being undertaken by the Corporate Accountability Network.

b. The Financial Reporting Council (FRC)

In contrast to the opinion offered by the International Financial Reporting Standards Foundation, UK Financial Reporting Standard 102 issued by the Financial Reporting Council[16] (FRC) makes clear that in its opinion the objectives of accounting are:

Objective of financial statements

2.2 The objective of financial statements is to provide information about the **financial position**, **performance** and **cash flows** of an entity that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs.

2.3 Financial statements also show the results of the stewardship of management – the accountability of management for the resources entrusted to it.

This accounting standard in question is largely used by medium sized entities located in the UK.

c. Discussion

As is apparent, these two statements conflict with each other:

- The FRC accepts a broad range of users of a set of financial statements whilst the IFRS Foundation defines a narrow user group;

- The FRC thinks that a there are a wide range of uses for the data in accounts, and the IFRS Foundation disagrees;

- The FRC emphasis the responsibility of the management of a reporting entity, including any PIE, for the stewardship of the assets entrusted to them. The IFRS Foundation assumes that this relationship of trust is severable at any moment because the relationship between the investor or supplier of credit is based on the purchase or sale of market instruments such as shares and debt.

It would seem as a consequence that accounts prepared in compliance with FRC requirements should be very different to those produced using IFRS. In practice this is not the case: the reality is that UK Financial Reporting Standard 102 issued by the Financial Reporting Council is based heavily upon the work of the International Financial Reporting Standards Foundation and imposes reporting requirements similar in very many ways to those required by IFRS.

[16] https://www.frc.org.uk/document-library/accounting-and-reporting-policy/2018/frs-102-frs-applicable-in-the-uk-and-republic-of-i

This is not to say that the difference in opinion does not matter, because there are occasions when it does. If an auditor is required to work out what is required of them when undertaking their duties these conflicting standards can create confusion for them, and also for the users of the financial statements, who should be expecting different standards of objectivity from the auditors depending on which standards are in use. Just to confuse matters further, some entities use IFRS for their consolidated accounts and UK FRC based standards for their parent company reporting, both being published in the same financial statements[17]. In that case the auditors are required to report on accounts prepared under two conflicting accounting frameworks that are published as one set of financial statements. It is hardly surprising that there might be audit risks arising as a consequence, and considerable uncertainty as to the purpose of any accounts and the attached audit report.

It is for this reason that we think a broadly based definition of the purpose of financial statements is required, which is what this Audit Briefing seeks to provide.

4. Our suggested purpose of financial accounts

It is our suggestion that the purpose of accounting has to be restated. We suggest that:

> *The purpose of accounting is to provide the stakeholders of a reporting entity with financial statements that include relevant, reliable and sufficient information which allow them to make informed decisions.*

We suggest that relevance is defined by a stakeholder's need, reliability means that the accounts are free from material misstatement and that sufficiency is determined in relation to purpose. These three qualities when taken together represent what we suggest to be a new meaning for 'true and fair' when applied to accounts that are fit for purpose in the twenty first century.

This definition does require that a number of additional issues are taken into account. In particular:

- Those who are the stakeholders of a reporting entity must be appropriately defined;
- The purpose of the user of the financial statements has to be reconsidered, and;
- Material misstatement requires further consideration.

[17] GlaxoSmithKline plc is an example of a company doing this. https://www.gsk.com/media/6662/annual-report-2020.pdf

We address these issues in the next three sections of this Audit Briefing.

5. The stakeholders of the accounts of PIEs

As we have explained in a separate Audit Briefing on who the stakeholders of a PIE might be[18], we think that those stakeholders are:

1. The shareholders of the PIE, if there are any, plus other providers of capital to the entity;
2. Trading partners of the entity;
3. Employees of the entity, whether past, present or future;
4. Regulators of the entity;
5. Tax authorities who engage with the entity;
6. Civil society in all its forms, however they might have interest in the entity.

It is our belief that the information needs of all these stakeholders should be addressed by the financial statements of PIEs and other reporting entities. The consequence would be that the content of those accounts would be very different to those currently prepared under either International Financial Reporting Standards or FRC Standard 102, both of which only seek to address one very particular need of the providers of capital to a company.

6. The purpose of the user of the financial statements

To establish the information needs of the stakeholders of accounts, which should in turn define the content to be included in the financial statements of a PIE, requires that the use that a stakeholder might make of that data is understood. This use defines the purpose that a stakeholder has for data.

The use that a person might make of accounting data varies considerably across the stakeholder groups. That said, some interests exist in common and so if already mentioned as being required by one stakeholder group in the list that follows they are not then repeated again.

In the list that follows the purpose of shareholders and other providers of capital to a company are differentiated where it is appropriate to do so because of their differing status and interests in the reporting entity. The lists that follow focus on high level requirements: elaboration is possible in all cases.

[18] Available from the Corporate Accountability Network website

a. Shareholders

The shareholders of a PIE require data for these purposes:

- To monitor the stewardship of the directors over the assets entrusted to their care;
- To monitor compliance with stated objectives and explanations provided for departures from expectation;
- To appraise the profitability of the reporting entity;
- To understand what part of those profits might be available for distribution to them as members. This requires in turn that if the PIE is a parent company of a group that the shareholders must understand what part of the profits of the group are available within its parent company and which part are recorded in subsidiary entities, and how much of that part in subsidiary entities might be available to the parent company in due course;
- To appraise the past and future cash flows of the company;
- To understand the solvency of the company and uncertainties inherent in its estimation;
- To understand the potential claims that others have on the entity and its cash flows that might prejudice the chance that they have of receiving a return from the PIE. Those claims might relate to uncertain claims as well as known liabilities, and both require disclosure as a result.

b. Other suppliers of capital to a company

The shareholders of a PIE are primarily concerned with the chance that they might have of making a return on their investment in its shares. Beyond that they have little interest in the entity as such, because they can very easily disengage from it if the shares that they own are traded on a stock exchange. This differentiates them from the other suppliers of capital to a company, although there are overlaps. In addition to the information that the shareholders require from a company, all of which is of interest to the other providers of capital, those providers of capital also require information on:

- The quality of the assets owned by the company as a means of providing security for the loan capital that they might provide to it;
- Which entities actually own the assets of the PIE, so that they can identify the particular risks in the provision of capital to the PIE as a whole, or to parts of it;
- Where the assets on which they might rely for security are located;
- What uncertainty there might be in the value of the assets in question;
- Who else might have claim on the assets in question;

- What the profits, cash flows and financial positions of the particular entities to which they provide capital might be.

What this data recognises is that by no means all the providers of capital to a PIE will necessarily deal with its parent company and that as a result information by subsidiary entity is as important to these suppliers of capital as is data for the PIE as a whole in a great many cases.

c. Trading partners of the reporting entity

Appraising the financial viability of the entity with which they actually engage is a key issue for trading partners, for which they reason they require the data reasonably expected by the suppliers of capital to the company, already noted. In a great many cases these trading partners will also be suppliers of capital to it because of the credit that they extend during trade. Since, however, trading partners are much more likely to engage with the subsidiaries of a PIE than with the parent entity there is a particular need to supply information based on location and by subsidiary entity of the PIE as a consequence.

The reasons for requiring this data include:

- Reviewing compliance with stated trading and payment policies, which should be referenced;
- Appraising solvency;
- Determining average periods of credit taken from trade suppliers;
- Seeking information on trade disputes and their resolution;
- Considering the likelihood that warranties will be honoured;
- Deciding on whether the risk of making deposit payments is worth taking.

The agencies on which many businesses rely when considering the supply of trade credit will obviously be important intermediary agencies in the use of much of this data

In addition to this data, many of those who trade with a PIE will also wish for data to appraise supply chain and other risks for environmental, social and governance (ESG) reasons. There is therefore a need to supply data on a range of these issues to meet the needs of this user group. The reasons for requiring this data are:

- To ensure compliance with a customer's own ESG standards including those relating to climate change and payment of a living wage as well as respect for human rights;
- To appraise the reputational risk of trading with the PIE;

- To bring pressure to bear upon the PIE to improve its standards as a condition of continuing contractual arrangements.

d. Employees

This section notes that employees past, present and future might all have interest in the financial reporting of the PIE.

It is important to note that the employees of a PIE are the stakeholders whose interests are very often most closely dependent upon those of the reporting entity itself. This is because many of those employees will have no other source of income apart from the PIE, and no other stakeholder group is likely to be in that position. It may also be the case that many employees will have much greater difficulty in breaking their association with the PIE than do other stakeholders such as shareholders, the providers of capital to the company, and trading partners. As such the provision of information for the benefit of the employees of a PIE is a matter of priority within financial accounts and justifies significant disclosure for the benefit of this stakeholder group.

Employees wish for information on the entity by which they are employed and on the group of which it is a part because they wish to:

- Review the stated employment policies of the PIE for which they should be held accountable;
- Appraise its solvency;
- Appraise its scale;
- To contextualise their pay and prospects;
- To understand its likely development as an employer and within the community it serves, of which the employee is likely to be a member;
- Know how their role fits in to that of the entity as a whole;
- Compare conditions in their part of the group which comprises the PIE to those in other parts of that same group;
- Understand their employer's employment policies, including with regard to equality in all its aspects;
- To understand the ESG policies of the company and group so that they can identify their own risk from association with the entity;
- To understand the funding of pension obligations and the commitment being made to fulfilling them.

As noted, this data will be required at subsidiary as well as group level since very few if any employees are ever employed by the parent entities of PIEs.

e. Regulators

All PIEs will be subject to review by a wide range of regulators. Much of the data that regulators might require can be demanded by them from those from whom they require it, but sample selection of those they wish to investigate requires data in addition to that already noted. In particular the regulators of a PIE need data to determine:

- The structure of the entity as a whole that they are regulating;
- The manner in which the parent entity of a PIE exercises control over its subsidiaries, joint ventures and uncertainties;
- The identity of any entities under the control of the PIE not reflected in its financial statements and a statement as to how they have been accounted for and where their accounts might be found on public record;
- To identify the means by which a parent entity within a PIE can impose its will on the entities that it supposedly controls;
- To identify the personnel responsible for manging the entity at each level at which it operates;
- The specific nature of the activities of each of the entities that they regulate and the purpose that they are meant to fulfil;
- The scale of each of the entities that they regulate;
- The level of the trade that takes place between each of the entities within the PIE since the ability to trade across borders also threatens the ability of a regulator to ensure compliance with their requirements.
- The financial viability of the entities that they regulate since they wish to be aware of the consequences of imposing regulation and the likelihood that the response to regulation might be to close an operation, and to manage the resulting risks.

f. Tax authorities

The aim of any tax authority is to ensure that those liable to pay tax within the jurisdiction for which they are responsible makes settlement of all their tax liabilities owing. In other words, they seek to determine whether a PIE and its constituent entities are tax compliant. Tax compliance is seeking to pay the right amount of tax (but no more) in the right place at the right time where right means that the economic substance of the transactions undertaken coincides with the place and form in which they are reported for taxation purposes. Tax authorities need significant amounts of information to achieve this goal. In addition to the data other regulators might require tax authorities are also likely to require the following information:

- The governance arrangements for tax within the entity;
- The entity's policy with regard to tax compliance;
- The nature of the sales of the entity, and the locations and entities (if intra-group) to which they are invoiced to assist the reconciliation of VAT liabilities declared to be owing by the PIE and its subsidiary entities within a location to those accounts;
- The number of employees of the PIE and its subsidiary entities within a jurisdiction together with the gross payment made to them, ideally split into broad bands, plus the value and nature of all benefits in kind provided to determine the reasonableness of declarations made for payroll related taxation liabilities;
- The value of pension contributions made;
- The nature of non-cash payments made to staff e.g. through share option schemes and other such structures to assist determination of appropriate taxation liabilities;
- Details of dividends paid, to be used in association with share registers to determine whether adequate controls exist to ensure that dividends are declared for tax purposes;
- The nature of the trade to determine liability for other direct and indirect taxes;
- The profit made by the entity by jurisdiction to determine whether it is profit shifting to low tax jurisdictions to avoid taxation liabilities, and the scale and direction of intra-group trade that might influence this profit reallocation;
- The location of group assets to the extent that it might influence the allocation of group profits;
- The location of key group trading activities to the extent that it might impact the allocation of group profits;
- A tax reconciliation for the PIE as a whole and for each subsidiary showing:
    - major indirect taxes whether value added tax or on other sales;
    - payroll related taxes;
    - tax on corporate profits

  showing:
    - opening tax liabilities
    - charges for the year
    - tax paid
    - closing tax liabilities owing

  with each item being reconciled to the relevant financial statements, included cash flow statements, in the accounts;
- A reconciliation of the corporation tax charge that separates items relating to current and deferred taxation and which reconciles the tax charge for the year with that which would appear to be due on the declared profit for the year;
- The uncertain tax positions of the entity i.e. those where liability cannot be determined with any certainty and there are sums subject to dispute, and where.

g. Civil society

Civil society has been the most ignored group within financial reporting. The reason is likely to be that the identity of the PIE is defined by contractual relationships. Accounting is almost entirely focussed upon measuring the transactions that cross the boundaries of that PIE as defined for contractual purposes. Auditing reinforces this by substantiating the truth and fairness of the consequences that arise from those contractual transactions. In varying ways all the stakeholders previously noted share contractual relationships with the PIE. In contrast, those stakeholders within civil society with an interest in a PIE will very often have no contractual relationship with it.

As such the whole point about civil society, and the way in which it is defined within this context of stakeholding, is that it is constituted by those that are interested in the PIE without having a contractual reason for doing so. Theirs is a relationship based not on contract, but on an awareness of tort. Tort is the branch of law where protection is sought from harm caused to a person by a party with whom they do not have a contractual relationship. The vast majority of civil society interest in the action of PIEs arises because of concern about the risk of such harm happening. The most common way in which such harm might happen would be as a consequence of what an economist might call an externality i.e. as a result of an unpriced third party consequence to an otherwise legal contact for which compensation is not paid contractually. Other abuses might arise from the PIE following the letter but not the spirit of the law.

As a consequence it is commonplace for those from civil society to want information on the impact of a PIE on the community of which they are a part. This means that the information required might as likely refer to a local community as it may to the entity as a whole. However, because of so many of the risks that civil society are interested in result from policy decisions taken at the level of the PIE itself all the matters referred to here are of interest within the accounts of the PIE itself.

Because of the nature of the risk that a PIE might create about which civil society might have concern will vary depending on the nature of the activity undertaken by the entity the range of disclosures required will require careful consideration by each PIE if material misstatement is to be avoided, but it is likely that civil society will want information to appraise performance on the following issues:

- Compliance with governance standards;
- Commitments to employees including with regard to pay, equality, diversity and disability;
- Executive remuneration because of its impact on inequality;

- Commitments to fair trade;
- Policy with regard to climate change, and the accounting made for it;
- Policy with regard to biodiversity and its active protection;
- Legal compliance;
- Taxation, where if the information noted to be required by tax authorities is made available most reasonable needs will have been met;
- Specific commitments to communities.

7. Material misstatement requires further consideration

International Standard on Auditing 450 (2016, para 4a) defines a misstatement in accounts as:

> *A difference between the reported amount, classification, presentation, or disclosure of a financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.*
>
> *When the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.*

This definition is inadequate. That is firstly because misstatement is defined solely within the context of an applicable financial reporting framework. Since, however, as noted in section 2a above, paragraph 1.11 of the International Financial Reporting Standards Conceptual Framework (IFRS 2018) suggests that '*financial reports are based on estimates judgments and models rather than exact depictions*' no financial reporting framework can reasonably be considered a definitive standard for this purpose, meaning that this definition must be flawed.

Secondly, the limitation on judgement that the conditions in the first paragraph impose on the scope for action required by the second paragraph means that the role of the auditor is unreasonably constrained. The consequence is that if they thought disclosure was required but the relevant financial reporting framework did not mandate it they could not demand that disclosure take place. This means that there is consequently no mechanism currently available that ensures that accounts might be reliable by being free from the risk of material misstatement, however it might arise.

In our opinion this requires that material misstatement have a different meaning. We suggest that:

> *Material misstatement of a set of financial statements occurs whenever:*
>
> - *Information relevant to a stakeholder's needs is omitted from a set of accounts;*
> - *Information is provided in such fashion that it is insufficient to fulfil a stakeholder's purpose in referring to the accounts;*
> - *A required disclosure is misstated to such an extent that it ceases to impart reliable information within the context of the use that a stakeholder might make of it.*

This definition is intended to relate to our proposed definition for the purpose of accounting. In another Audit Briefing we will also relate it to our suggested purpose for audit.

What is key to this suggested definition of a material misstatement is that:

- It is defined from the perspective of the stakeholder;
- Materiality is also defined from the stakeholder's perspective;
- Misstatement is not merely quantitative; it can also be an act of omission or of misrepresentation;
- Because the needs of the stakeholders of an entity are not defined or constrained by any accounting framework judgement is required to determine what might be a misstatement and what materiality might be with regard to any issue, and it will be for a company, its officers and its auditors to defend their judgement;
- The bias inherent within this definition is towards unambiguous disclosure.

8. Discussion and conclusion

In this Audit Briefing we have demonstrated that the current framework that defines the purpose and content of financial statements, or accounts as we prefer to call them, is judgemental, conflicted and far too limited in scope to be of use to the majority of the stakeholders of PIEs, all of whom will have legitimate interest in its accounting data even though they are deemed not to have such claim by the International Financial Reporting Standards Foundation.

We propose a replacement definition of accounting in this Audit Briefing that rejects most of the assumptions made as to purpose and limitation of scope adopted by IFRS and puts in their place a stakeholder focus to accounting. The aim is to ensure that the need of the

reasonably anticipatable stakeholder of a PIE to secure the information that they need to satisfy the purpose that they have for making enquiry of that entity is met.

One over-arching theme of the analysis of needs that follows on from this suggested purpose for accounting is that the data required by stakeholders about any PIE is as likely to relate to its activities locally and within specific subsidiary entities as it is within the PIE as a whole. The time when it was presumed that the consolidated accounts of a homogenous parent entity which never actually undertakes the selected range of transactions that its accounts report[19] could meet all stakeholder need have long gone. Even the suppliers of capital to a company, whether they be the shareholders or providers of loan finance have obvious need for local and subsidiary data which they are too often denied at present. Other stakeholders usually have local concerns about the PIE, all of which do, however, have to be understood within the context of that interest being framed by the activity of the PIE as a whole. What this makes clear is that the understanding that the accounts of a PIE are singular is no longer true: if the PIE is to account for its activities reporting at multiple levels is required.

Another recurring theme is that the data required by many of the stakeholders of accounts has little to do with the financial return due to the providers of capital. The model of accounting that the IFRS Foundation has chosen to adopt that makes this need paramount is wrong. It does, however, also fail some of the most basic needs of those users. When in most PIEs the relationship between the entity and the shareholder is transient at best the only basis for its perpetuation is the expectation of a future dividend stream. That is in turn dependent upon the availability of realised distributable reserves and yet IFRS accounts do neither disclose the technical availability of such reserves or the practical ability of the group parent entity of the PIE to access them within its subsidiary companies. As such at this most basic level IFRS accounts fail. Because IFRS accounts also fail to disclose the location and extent of the security available to loan financiers they also fail at that level as well. When it comes to other stakeholders these failings are compounded.

In that case the new definition of accounting that we propose is, we suggest, required. That suggestion is that:

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[19] The consolidated accounts of the parent entity of a PIE suggest that the parent entity undertakes transactions which are actually undertaken in subsidiary companies for which the parent entity usually has little or no actual legal liability whilst excluding from view all the intra-group transactions that take place and which usually have material impact on the allocation of profit to legal entities and jurisdictions within the group as a whole, which transactions would frequently be of concern to the stakeholders identified in this Audit Briefing.

> *The purpose of accounting is to provide the stakeholders of a reporting entity with financial statements that include relevant, reliable and sufficient information which allow them to make informed decisions.*

It is worth briefly speculating as to what this might mean in practice. First, the emphasis on reliability might well require a review of the use of fair value reporting in financial statements. This use has resulted in the accounts of most PIEs being dominated by data that has no relationship with any actual transaction ever undertaken by the reporting entity. That makes those accounts inherently unreliable.

Second, we suggest that there will be a much greater emphasis on subsidiary and jurisdictional reporting within those accounts.

Third, we believe that stakeholder reporting will refocus the whole process of accounting so that the needs that we note in this Audit Briefing are met.

Useful financial statements will as a result look very different from those that we now have.

9. About the Corporate Accountability Network

This briefing has been published by the Corporate Accountability Network[20].

The Corporate Accountability Network (CAN) recognises that accounting as a whole is facing a crisis of relevance since it is failing to meet the demands made of it by the users of the financial statements that the accounting profession produces. The Corporate Accountability Network exists to identify the causes of that crisis and offer solutions to it.

CAN is pro-business and it is pro-accountancy. What it does not accept is the idea that accounts, accountancy and accounting exist solely to serve the interests of one group in society. They do not. Accountancy was created with a public purpose. CAN believes that it should fulfil that public purpose.

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What CAN argues is that accountancy can never fulfil that purpose that unless it fulfils its obligation to account to all the stakeholders of a company, whether they be the suppliers of its capital; its trading partners; its employees; regulators; tax authorities and civil society – who are everyone it impacts whether or not it has a contract with them.

CAN recognises that we live in a mixed economy where the state and private sectors co-exist to meet our needs. That economic model has worked, and could survive long into the future even with the challenges that issues such as climate change create. But that will only be true if business continues to enjoy the confidence of those who provide it with its licence to operate – which is society at large. It will not do that unless business accounts to everyone in society. The Corporate Accountability Network exists to show that accounting in this way is possible, necessary and achievable.

10. About the author of this Audit Briefing

This Audit Briefing has been produced by Professor Richard Murphy. Richard is Professor of Accounting Practice, Sheffield University Management School[21] having previously been Professor of Practice in International Political Economy at City, University of London. He is a Fellow of the Institute of Chartered Accountants in England and Wales, from whom he holds a UK practicing certificate, entitling him to practice as a chartered accountant.

Richard was senior partner of an accounting firm for more than a decade before becoming involved in tax justice campaigning. He co-founded the Tax Justice Network[22], the Fair Tax Mark[23] and Finance for the Future[24]. He founded Tax Research UK[25]. He co-created the Green New Deal[26]. He is founder-director of the Corporate Accountability Network[27].

Richard created the concept of country-by-country reporting[28], which is now in use in more than 90 countries around the world to identify tax abuse by multinational corporations as a result of backing for it provided by the Organisation for Economic Cooperation and Development[29].

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[21] https://www.sheffield.ac.uk/management
[22] https://taxjustice.net/
[23] https://fairtaxmark.net/
[24] https://www.financeforthefuture.com/
[25] https://www.taxresearch.org.uk/Blog/
[26] https://greennewdealgroup.org/about-the-group/
[27] http://www.corporateaccountabilitynet.work/
[28] http://visar.csustan.edu/aaba/ProposedAccstd.pdf
[29] https://www.oecd.org/tax/beps/beps-actions/action13/

Richard has created the concept of sustainable cost accounting[30].

Richard has authored a number of books including The Courageous State and The Joy of Tax. He blogs, usually daily, at Tax Research UK[31] and is a frequent commentator in the media on tax and accounting issues. In both 2019 and 2020 the Institute of Chartered Accountants in England and Wales named him as the top social media influencer on accounting issues in the UK[32].

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[31] http://www.taxresearch.org.uk/Blog/

[32] https://www.icaew.com/about-icaew/icaewroar/icaewroar-top-online-uk-influencers-accountancy-2020

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