AUDITING PROBLEMS IN RELATION TO HIDDEN RESERVES
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Nature of hidden reserves

For the purposes of this discussion hidden or secret reserves may be divided into two kinds. The first is confined to undisclosed applications of profits to reduce by an amount materially greater than is necessary the amounts at which assets are stated in the books of an undertaking, to provide amounts materially greater than are required to meet liabilities, losses and commitments, and to write off capital expenditure on additions to plant, buildings and other assets as if it were an ordinary working expense of the year. This type of hidden reserve is one to which the term „reserve" is strictly applied in accordance with the recognised meaning attached to that term in publications of The Institute of Chartered Accountants in England and Wales and in the United Kingdom Companies Act, 1948.

The second type is one where the term is used in a more popular and less technical sense but may, nevertheless, be of considerable importance in some circumstances. It arises where, unless accompanied by supplementary information, the use of the historical cost basis of accounting - which is the basis normally used in the United Kingdom - would result in failure to reflect and disclose material appreciation in the value of assets or other facts of a character highly relevant to an adequate understanding of the significance of the accounts and the state of the company's affairs.

The first type of hidden reserve is now virtually prohibited except in a relatively small field in which special bodies such as banks enjoy exemption; the second can still arise to some extent and may, therefore, need disclosure or comment in order that the accounts may shew a true and fair view. The auditor has, therefore, to use his own judgment as to whether the situation is such that he must refer to the matter in his report.

Historical

A great change has taken place during the last thirty years in the attitude in the United Kingdom towards the creation, retention and use of the first type of hidden reserves mentioned above. Before that time directors of companies regarded themselves as well advised in the interests of the shareholders to use their discretion in writing down assets to an extent greater than was required and withholding disclosure of the extent of this action, in setting aside undisclosed reserves in order to meet future contingencies and in charging off capital expenditure as operating expenses of the year. Provided there was disclosure of the fact that such action had been taken, the auditors of companies regarded themselves as not having ground for objection to non-disclosure of the magnitude of the amount so treated except in extreme situations where the amounts concerned were flagrantly excessive. It was, however, the view of eminent accountants that the use of such reserves to reduce losses or supplement profits in subsequent years should be disclosed and preferably that the amount so used in any year should normally be stated in the accounts.

In other words, the view was that whilst the amounts taken out of profits to hidden reserves need not be disclosed unless they were so great as to destroy the validity of the accounts, it was desirable for the auditor to ask that the extent, if any, to which they were put back into the profit and loss account in later years should normally be shewn. It was thus considered reasonable to understate the profits of a year to a moderate extent by making allocations to hidden reserves, but not to overstate the profits by bringing back amounts from previous allocations without disclosure.

From about the year 1931, following the great awakening of interest in this matter caused by the famous Royal Mail case in the courts, this attitude towards hidden reserves changed rapidly. The weight of responsible professional opinion became increasingly in favour of the maximum practicable disclosure in accounts. It was recognised more and more that this was essential to an adequate appreciation both of the financial position of an undertaking and of its profits of the year as well as of the trend of profits over a series of years. From 1943 onwards The Institute of Chartered Accountants in England and Wales issued successive recommendations on accounting principles which further accelerated this change. These recommendations had great influence on professional thought and on business practices. They received public endorsement in the report of a government committee on Company Law Amendment whose proposals led to the enactment of the Companies Act, 1948 and to parliamentary approval of the practices which the Institute had recommended on this subject.

A proper appreciation of the present United Kingdom outlook on hidden reserves and the auditor's attitude and duties in relation to them can, therefore, best be obtained by considering the Recommendations on Accounting Principles issued by the English Institute and the requirements of the Companies Act, 1948.

Basic accounting requirements of Companies Act 1948

The Act of 1948 requires each company to prepare and submit to its shareholders every year accounts which shew a true and fair view of its profit or loss for the financial year and of the state of its affairs at the close of the year. The Act also requires that for purposes of comparison these accounts shall include corresponding amounts for the immediately preceding financial year for all items shewn in the accounts.

Auditors independent of the management have to be appointed by every company to examine the books and accounts and report to the shareholders whether the accounts have complied with this and other requirements. The auditors of companies in which the general investor owns shares and certain other companies have to be members of certain recognised United Kingdom bodies of accountants or accountants who have similar qualifications obtained abroad; the auditors of other companies do not require these qualifications.

The reports of the auditors of each company have to be attached to its accounts and have to be read at the annual meetings of shareholders. Any material secretion of profits or undisclosed bringing back of profits and any undisclosed material change in the basis of accounting so as to create or use a hidden reserve would cause the accounts to fail to be true and fair and, therefore, would infringe the requirements of the Act. It would be the duty of the auditors to report the failure when reporting on the accounts.

The Act does not prescribe a standardised form of accounts but contains detailed requirements as to the extent of the information which must be disclosed in them. The requirement that the auditors shall state in their report whether the accounts comply with the Act means that they must not only consider and report whether in their opinion the accounts give a true and fair view of the state of affairs and the profit or loss of the year but also have regard to these detailed requirements. Some comments on the requirements so far as they concern hidden reserves will, therefore, be appropriate.

Distinction between „provisions" and „reserves"

An important point in relation to hidden reserves is that the Companies Act, 1948 accepted the view of the English Institute that there is an important difference between the meanings attached respectively to the terms „reserves" and „provisions". The expression „provision" means an amount necessarily written off or retained to provide for depreciation, renewals or diminution in value of assets or necessarily retained to provide for meeting a known actual accruing or contingent liability. The expression „reserve" does not include items covered by the expression „provision" but includes any excessive amount set aside for the purposes for which provisions are made and all profits set aside as matters of policy for equalising dividends or otherwise retained to assist in providing capital resources for the business or for meeting future contingencies other than losses incurred or accruing at the close of the accounts.

It, therefore, follows that the auditor has to look at all items described as provisions in order to see whether, and, if so, to what extent, they are in fact reserves and as such are subject to the disclosure requirements of the Act specifically affecting reserves. The duty of preparing the accounts and of deciding whether a particular item is a reserve or a provision rests first upon the directors but the auditor has to consider whether they have discharged this duty. He has the right to call upon them for information and explanations to assist him in forming an opinion on this matter. If he does not receive adequate replies or is not satisfied that the amounts shewn as provisions are properly so shewn it is his duty to mention the matter in his report and make a reservation to an appropriate effect.

Disclosure of reserves and movements therein

The Act specifically provides that where the amounts are material the aggregate amounts of the capital reserves and of the revenue reserves shall be shewn in each balance sheet at the close of the financial year under separate headings and that the amount, if material, set aside or proposed to be set aside to or withdrawn from reserves shall be shewn in the profit and loss account. The amount of any surplus provision which is brought back into profits is also to be shewn if material.

Where the amount shewn in the balance sheet for any item of reserves shews a material increase or decrease as compared with that of the previous year the source of the increase or the use of the reserves which has caused the decrease is to be stated unless the reason is sufficiently indicated in the profit and loss account or in a note on the accounts.

It will thus be seen that properly drawn accounts necessarily disclose reserves and amounts which are set aside to or withdrawn from them and that, therefore, such items cannot be hidden reserves if the accounts comply with the requirements. Part of the auditor's duty is to see that this compliance is made.

Fixed assets

The method or methods used in arriving at the amount shewn under each heading for the fixed assets must be stated in the accounts. With certain exceptions it has to be the excess of either the cost, or, if the asset has been revalued and is so stated in the books, its valuation, over the total amount provided since its purchase or valuation as the case may be for depreciation or diminution in value. The cost, or valuation, and the total so provided to date have both to be shewn. Moreover, the amount charged in the profit and loss account of the year for these purposes or for renewals of fixed assets must be shewn in the accounts.

Where any amount provided for depreciation, renewals or diminution in value of assets is in excess of that which in the opinion of the directors is reasonably necessary for the purpose, the excess must be treated in the accounts as a reserve and not as a provision. This means that any excessive writing down of fixed assets is not only inconsistent with good accounting practice but is also in conflict with legal requirements. Moreover, it would not be possible without infringing the law to charge material amounts of capital expenditure on additions to plant, buildings and other assets as an ordinary working expense which is treated as expenditure on maintenance or repairs. This does not prevent directors from exercising reasonable prudence in deciding how quickly the cost of an asset should be amortised by charges to revenue but it does prohibit material unreasonable and deliberate understatement of profits by this means.

The auditor's function in relation to this matter is to see that provisions are made for depreciation, renewals and diminution in value of the fixed assets in accordance with a recognised and consistent practice. He will use his own experience and knowledge of other businesses in forming a provisional opinion as to whether the method used looks reasonable. The directors and officers must use their expert knowledge in estimating the probable effective commercial lives of the fixed assets and must decide which of the recognised methods of making provisions will best suit the circumstances of their company; the auditor naturally gives full weight to their views. He is authorised by law to call for information from them in order to satisfy himself that they have established a proper basis for and used a recognised and consistent method in making their calculations. If, however, he is not satisfied that their explanations and the decisions taken by them in preparing the accounts are on a reasonable and consistent basis he will record the facts in his report as auditor and will include an expression of any views which he can properly form on the mattter .While he cannot pose as a technical expert on the probable useful life of plant and machinery he is not thereby prevented from using his critical faculties as a person with business experience.

It thus follows that the arbitrary writing down of fixed assets without justification in order to reduce the profit shewn by the accounts of a year or to reduce the company's disclosed reserves, or a material change in the basis of provision for depreciation would be a matter requiring disclosure. If the accounts fail to make adequate disclosure the failure would become a matter for immediate comment by the auditor in his report on the accounts.

If, however, there were a considerable appreciation brought about by inflation in the prices of land and other property or in the value of other fixed assets retained for the purposes of conducting the business, that is not held for sale, the application of the historical cost basis of accounting would normally involve the continued statement of such assets at their historical cost (less depreciation) and there would be no obligation of law or accounting practice to disclose such appreciation or its amount. The accounts would disclose that the fixed assets used as such in the business are included on the cost basis and even where it has been known that in terms of market value they could be sold for a considerably greater sum, it has not hitherto been regarded as necessary to make reference to this in the accounts.

Provided that the auditor was satisfied that the basis used was disclosed, he equally would have no hesitation in saying that in his opinion the accounts shew a true and fair view. His justification for this practice would be that his opinion is known to be expressed as to the truth and fairness of the accounts in relation to the historical cost basis and not in relation to current values and unrealised profits which may be latent in the accounts.

Once such profits are realised by sale, however, a different situation arises. The auditor must see that any profits realised on the disposal are not taken to undisclosed reserves nor applied in writing down other assets without disclosure or to an extent which is not made necessary by reason of diminution in value. They must be included in the amounts disclosed as profits of the year or as movements taking place during the year on the capital or revenue reserves as the case may be.

An exception to the general rule is made for a fixed asset which represents goodwill, patents or trade marks. The amount applied to write it down in any year and the source of the provision must be shewn; but in subsequent years, even though the asset continued to be worth an amount equal to or in excess of its original cost or valuation, the amounts previously written off would not be viewed in United Kingdom accounting or auditing practice as requiring disclosure nor as constituting hidden reserves if not disclosed.

Investments

If there were no restriction upon concealment of the significance of investments and no opposition from the auditors it would be a relatively easy matter for a company to conceal from its shareholders the extent of any hidden reserves arising in relation to the company's investments. These hidden reserves might either be of the kind made by applying profits or other reserves to write down excessively the amounts at which the investments are stated (that is reserves in the strict legal and professional sense as defined in the opening paragraph of this article) or of the sort which arise in the more popular meaning of the term because of a large enhancement having occurred in the market value of investments which are carried in the books at their original cost. The requirements of the law and recognised accounting practice largely, though not entirely, prevent both these types of concealment.

Investments in subsidiaries formerly provided considerable opportunity for concealing the real strength of an undertaking but this has been prevented by the practice which has been a statutory obligation since 1948, of submitting group accounts by way of supplement to a holding company's separate accounts. This procedure and its effect are dealt with further below under the heading of „Investments in subsidiaries".

As to other holdings the market value of quoted investments (that is investments quoted or dealt in on a recognised stock exchange) owned by the company, other than trade investments, must be disclosed either by way of note or by adoption in the books. The auditor can check these values by reference to stock exchange lists of dealings and quotations and thus satisfy himself that no hidden reserve is concealed in the valuations. He has a duty to do so.

If their current market value is shewn, other investments held as fixed assets need not have disclosed in relation to them the extent to which their cost has been written down. If they are trade investments, however, there is no specific requirement that their current market value shall be disclosed, and each company has, therefore, a choice as to the course it will pursue in regard to this class of investment. Trade investments are not precisely defined but may broadly be described as investments (other than shares in subsidiaries) held in connection with the company's business. They include a holding which is substantial in size but does not give control of a company associated with the owning company in its trading activities.

The current values of trade investments and of any unquoted securities owned by the company are matters for special consideration by the auditor, both for the purpose of ensuring that any necessary provision is made to write down investments carried at an excessive value and also for the purpose of forming an opinion based on all available information as to the extent to which, if at all, the amounts at which trade investments and unquoted securities are carried understate their real current worth to the company. The investments may be in highly profitable associated companies which distribute only a trivial proportion of their profits and have very large undistributed reserves. The dividends received by the owning company may be no adequate guide to the real value of the investment and the auditor may conclude that without additional information the book amount of the investments does not enable a fair view of value to be formed. If in his opinion there is such an understatement the auditor then needs to consider whether this is so important that the accounts of the company will fail to a material extent to shew a true and fair view unless additional information as to current profits and past retentions of profits is given in the accounts by way of note or otherwise in order to correct this deficiency.

There are no specific statutory requirements to include such notes nor otherwise about this matter other than the overriding duty of the directors to present accounts which shew a true and fair view of the state of the company's affairs and the duty of the auditor to form his opinion as to whether the accounts submitted comply with this requirement. Instances have occurred where the auditors of companies have found it necessary to qualify their reports where they have found seriously inadequate the information given in this respect but it is only fair to say that such instances do not appear to be very numerous.

Investments in subsidiaries

In the last decade prior to the outbreak of the second World War there was a growing realisation that the separate accounts of a holding company with substantial interests in subsidiaries were wholly inadequate as a presentation of its affairs and profits unless they were accompanied by additional information in the shape of consolidated and similar accounts.

Instances had been known of companies whose subsidiaries were extremely valuable and profitable and had built up large reserves of undrawn profits of which the accounts of the owning companies gave little indication. Absence of information as to the earnings and reserves of such companies not only made it easy for erroneous inferences to be drawn as to the value of the shares but also allowed a holding company to withdraw in dividend from the past retentions of profits by subsidiaries larger dividends than their earnings of the year without disclosing the extent to which this was being done. This situation was realised to be unsatisfactory and a movement developed from the 1920's onwards in favour of the presentation of group accounts which would disclose the underlying profits and profit retentions which lay beneath the items of investments in subsidiaries appearing in the balance sheets of holding companies.

The English Institute lent its weight in favour of this movement and so recommended to its members as well as to the government committee whose recommendations in turn led to the Companies Act, 1948. The result was that the presentation of consolidated or other group accounts as part of the accounts of a holding company became obligatory.

The auditor of a holding company now has to state in his report whether these group accounts have been properly prepared so as to shew a true and fair view of the position and of the profit of the group from the standpoint of the members of the holding company.

The group accounts have to give for the whole group information equivalent to that which would have to be presented in the accounts if the group were itself a single company, the result being that it is no longer practicable for the underlying profits and reserves of a group to be concealed from its shareholders nor for the use of the profits to be manipulated in the way indicated.

Stock in trade and work in progress

The omission of stock or work in progress from accounts or its statement in the accounts at an amount materially below its cost or realisable value would involve the creation of a hidden reserve as it would reduce the amount which would otherwise be shewn as trading profit and might seriously misrepresent the company's financial position. The subsequent realisation of the stock or work in progress would result in an undisclosed inflation of the profit of the realisation period. The result would be that the profit and loss account and balance sheet of the period of omission or understatement and the profit and loss account of the realisation period would fail to shew a true and fair view.

The auditor's examination of the accounts involves the performance of important duties in relation to stock in trade. He is not a valuer but has to use his experience and knowledge of accountancy and business and apply such tests as are within his competence in satisfying himself that all the stocks and work in progress are included and are stated on a recognised and consistent basis. His audit tests are designed, inter alia, to enable him to form an opinion as to whether adequate but not excessive provisions have been made for any losses which may properly be deemed to have arisen at the accounting date.

If, after considering the results of his tests and other enquiries and any explanations tendered by the directors he is not satisfied that the stocks are fairly stated, his duty is to make an appropriate reservation in his report to the shareholders. He will normally make such a reservation only where the extent to which he is dissatisfied is material in relation to the profits or financial position disclosed by the accounts.

Accounts receivable and provisions for liabilities and losses

Other current assets such as accounts receivable and also the amounts provided for liabilities and expected losses likewise require examination by the auditor in order to see whether these are fairly stated. Excessive provisions for bad debts and other possible losses must be treated and disclosed in the accounts as reserves and, therefore, the auditor must consider not only whether the provisions made are adequate but also form an opinion as to whether they are excessive to a material extent. In the latter event he must qualify his report on this account.

Redemption of share and loan capital

The amounts provided by way of charge to profit and loss account for the redemption of share and loan capital in each year must be shewn in the accounts and any profit made on redemption must be carried to a disclosed reserve. It, therefore, follows that it is not possible for the profits shewn by accounts which comply with the requirements to be understated by reason of charges of undisclosed amount having been made for these purposes.

Where a company buys back its own debentures through a nominee or trustee and refrains from cancelling them the accounts have to shew the nominal amount of the debentures so held as well as the amount at which they are stated in the books of the company. The effect is that if the debentures have been repurchased at a price well below the nominal amount of the liability upon them the accounts must shew clearly the extent of the profit which has been made by the repurchase but has not yet been taken to a reserve account or to profit and loss account. The auditor has to see that this is done.

Conclusion

It will be seen that the making, retention and undisclosed use of hidden reserves by industrial and commercial companies is not permitted in the United Kingdom. Exceptions are permitted for a very small range of undertakings, mainly in the banking and insurance field, and other exceptions may be made in special circumstances where specific sanction is granted by the Board of Trade. These, however, are negligible in relation to the vast number of British companies which have to comply with the requirements in full.

The auditor's duties are to see that the accounts shew a true and fair view and this cannot be done if there is concealment of reserves of material amount; accordingly the auditor has to form an opinion on this matter when he is preparing his report on the accounts and, if necessary, to state the fact and extent of such concealment. There is no doubt whatever that a tremendous advance has been made in this respect in the last thirty years. The auditor's position has been strengthened by the guidance given to him by the Institute and by the enactment of statutory requirements in terms which have imposed duties on directors and auditors without, however, depriving them of reasonable initiative.