

**TECH 01/11: GUIDANCE FOR DIRECTORS ON ACCOUNTING RECORDS UNDER THE COMPANIES ACT 2006**

Contents	Paragraph
Introduction	1 - 4
The legal requirements	5 - 9
The accounts to which this requirement to maintain adequate accounting records applies	10 - 13
Contents, form and organisation of accounting records	14 - 15
Preservation of the accounting records	16 - 17
Disclosure of the financial position at any time	18 - 24
Cash records to be kept	25 - 26
Assets and liabilities	27
Stocks	28
Purchases and sales of goods	29
Penalties and disqualification orders	30 - 32

This Technical Release provides general guidance and does not purport to deal with all possible questions and issues that may arise in any given situation. ICAEW do not accept responsibility for loss caused to any person who acts or refrains from acting in reliance on the material in this publication, whether such loss is caused by negligence or otherwise.

Introduction

- 1 Section 386 of the Companies Act 2006 obliges all companies to have accounting records satisfying the requirements set out in that section. The term 'accounting records' was introduced by the Companies Act 1976 in recognition of the fact that the term 'books of account' (used in earlier Acts) was no longer apt. It was concern about the incidence of fraud and negligence that originally directed attention to the need for guidance on the interpretation of this section. This resulted in the issue in 1992 of FRAG 5/92, which provided guidance on the interpretation of section 221 of *the Companies Act 1985*. This Technical Release is an updated version of that original guidance, which reflects changes in companies legislation brought about by the *Companies Act 2006* and other developments.
2. Since 1976, and since the 1992 guidance, accounting practices, both in terms of treatments in accounts and systems for capturing and processing financial information, have evolved significantly. However, the Act's requirements with respect to accounting records remain framed in substantially the same terms as they were in the 1976 Act. The Act does not mandate that companies adopt the highest possible standards of record keeping systems, but sets only a minimum threshold as to the records that must be kept. The requirements, applying to all companies regardless of how large and global, or how small and local their businesses may be, could not aim at anything else. This is acknowledged in the explanatory notes to the *Companies Act 2006*, which say:

Accounting records is a broad term and there is no specific definition as the records may differ depending on the nature and complexity of the business. For a simple business these may include, for example, bank statements, purchase orders, sales and purchase invoices, whilst a more sophisticated business may have integrated records, which it holds electronically.' (Explanatory notes to the *Companies Act 2006*, para 639)

It should also be emphasised that the requirements are concerned with specifying the matters that must be recorded and not with the system, including its internal controls, by which a company might make such records. Thus, for example, matters of internal controls are outside the ambit of section 386.

- 3 No account is taken in this paper of specific requirements of other legislation¹ (eg VAT legislation) in respect of accounting records. In addition, the records that need to be maintained in order to manage the business may well go beyond the Act's minimum; such records are not covered by this technical release. As discussed in Tech 6/08 *Financial and accounting duties and responsibilities of directors*, the directors have an overriding responsibility to ensure that they have adequate information to enable them to discharge their responsibility to manage the company's business (Tech 6/08, para 69).
- 4 Counsel has confirmed that the guidance is consistent with the law at 1 December 2010. Counsel accepts no responsibility (other than to the Institute) in relation to advice ascribed to him in this guidance.

¹ For information on these requirements, please refer to the Tech 6/08 *Financial and accounting duties and responsibilities of directors*, para 76.

The legal requirements

5 The Act's requirements are as follows:

386 *Duty to keep accounting records*

- (1) Every company must keep adequate accounting records.
- (2) Adequate accounting records means records that are sufficient –
 - (a) to show and explain the company's transactions,
 - (b) to disclose with reasonable accuracy, at any time, the financial position of the company at that time, and
 - (c) to enable the directors to ensure that any accounts required to be prepared comply with the requirements of this Act (and, where applicable, of Article 4 of the IAS Regulation).
- (3) Accounting records must, in particular, contain –
 - (a) entries from day to day of all sums of money received and expended by the company, and the matters in respect of which the receipt and expenditure takes place, and
 - (b) a record of the assets and liabilities of the company
- (4) If the company's business involves dealing in goods, the accounting records must contain –
 - (a) statements of stock held by the company at the end of each financial year of the company,
 - (b) all statements of stocktakings from which any such statement of stock as is mentioned in paragraph (a) has been or is to be prepared, and
 - (c) except in the case of goods sold by way of ordinary retail trade, statements of all goods sold and purchased, showing the goods and the buyers and sellers in sufficient detail to enable all these to be identified.
- (5) A parent company that has a subsidiary undertaking in relation to which the above requirements do not apply must take reasonable steps to secure that the undertaking keeps such accounting records as to enable the directors of the parent company to ensure that any accounts required to be prepared under this Part comply with the requirements of this Act (and, where applicable, of Article 4 of the IAS Regulation).

6 The key requirement is in section 386(2). Subsections (3) and (4) supplement this.

7 The 2006 Act requires companies to maintain 'adequate' accounting records. This drafting is different from the requirements of the 1985 Act, which made reference only to 'accounting records' (section 221(1)). However, 'adequate accounting records' is defined in the same way as 'accounting records' was under the 1985 Act, ie that they be sufficient to meet the three purposes set out in (what is now) sub-sections (2)(a)-(c), and this change in drafting has no substantive effect. Thus, in this respect, both the old and the new legislation involve the same qualitative standard.

8 It is noted in passing that in the 2006 Act, the language of these requirements is consistent with the auditor's reporting duty in section 498(1)(a) – ie, the auditor is required to form an opinion whether adequate accounting records have been kept by the company. Whilst this is a difference in language, compared with the position under the 1985 Act, where an auditor was required to form an opinion as to whether 'proper' accounting records had been kept, there is no change to the substance of the requirement on auditors to report on the company's accounting records.

9 Section 387 contains penalty provisions. These are discussed in paragraph 30 below.

The accounts to which this requirement to maintain adequate accounting records applies

10 Adequate accounting records must be kept to enable the directors to ensure that any accounts required to be prepared comply with the requirements of the *Companies Act 2006* and, where applicable, Article 4 of the *IAS Regulation* (section 386(2)(c)).

11 The language of the Act differs from that of the 1985 Act, which applied to accounts required to be prepared *under Part VII of the 1985 Act*. Thus, the language of the Act is wider than that of the 1985 Act, and raises a question as to whether the record keeping requirement applies to any accounts required to be prepared eg, monthly management accounts required to be prepared by a banking agreement. However, later wording in the section requires the records to enable such accounts to comply with the Act (or the *IAS Regulation*). Accordingly, the drafting of the 2006 Act extends the statutory requirement to apply in relation to accounts that are required to be prepared pursuant to the Act or the *IAS Regulation*, but no further.

12 However, as a result, that wider language makes it clear that under the Act the requirements of section 386 do apply in relation to those accounts that are required to be prepared by a provision in the Act that sits outside Part 15 – eg, initial and interim accounts required to be prepared by Chapter 2 of Part 23 of the Act for the purpose of making a distribution.

13 Although consolidated accounts may be required under Part 15 of the Act or under the *IAS regulation*, the record keeping requirement covers only the company's transactions (some or all of which, of course, are included in the consolidated accounts).²

Contents, form and organisation of accounting records

14 The accounting records should comprise an orderly, classified collection of information capable of timely retrieval, containing details of the company's transactions, assets and liabilities. An unorganised collection of vouchers and documents will not suffice: whatever the physical form of the records, the information should be so organised as to enable a trial balance to be constructed. If, for example, the information is held in electronic form as a subset of a set of wider information, the software should be capable of retrieving the appropriate data.

15 Section 1135 makes basic provisions with regard to the form of company records, which includes accounting records (section 1134). These may be kept in hard copy or electronic form, and arranged in such a manner as the directors think fit provided the information that is recorded is adequate for future reference. Where records are kept in electronic form, they must be capable of being reproduced in hard copy form.

² A parent company that has a subsidiary undertaking in relation to which section 386 does not apply (e.g. an overseas subsidiary), is required by sub-section (5) to take reasonable steps to secure that subsidiary keeps such records as are needed to enable the parent company's directors to prepare any accounts required to be prepared under Part 15 of the *Companies Act 2006* (including consolidated accounts). This guidance does not address this element of the requirements.

Preservation of the accounting records

- 16 Section 388 of the Act requires that accounting records, once made, must be preserved for at least 6 years (public companies) or 3 years (private companies). It follows that where software is needed for retrieval of information in usable form, it must be available for use for the same period, as must any necessary hardware.
- 17 However, owing to other legal obligations, eg tax legislation, companies usually need to preserve accounting records for longer than those periods given by section 388. For a more detailed discussion of these requirements, please refer to the Tech 6/08 *Financial and accounting duties and responsibilities of directors*, para 73 et seq.

Disclosure of the financial position at any time

- 18 The Act requires that accounting records should be such as to disclose with reasonable accuracy, at any time, the financial position of the company at that time. The words 'at any time' emphasise the obligation to keep accounting records up to date. The words 'at any time ... at that time' make clear that it does not impose an obligation to keep accounting records capable of disclosing the financial position at any time in the past. The requirement to keep accounting records up to date does not mean that transactions and events must be recorded instantaneously. It is sufficient if they are recorded within a reasonable time. What is a reasonable time depends upon the nature of the business and other circumstances. For example, a company with a very high volume of transactions, may need to write up its records with greater frequency, than a business that does not have such volume, in order to be in a position to disclose its financial position at any time.
- 19 The data in accounting records should be such as would enable the directors at any time to prepare a reasonably accurate statement of the company's financial position. The financial position is not limited to the cash position. It comprises the assets and liabilities including items such as those referred to in paragraph 23 below. The accounting records should therefore contain the primary material on which a set of accounts would be based.
- 20 However, they need not contain whatever additional items of information it would be necessary to include in statutory accounts in order to make those accounts true and fair (see paragraph 23 below). In requiring that the accounting records be sufficient to disclose with reasonable accuracy, at any time, the financial position of the company at that time, the Act recognises that it is not practicable to keep accounting records in such a way as to enable accounts to be prepared giving a true and fair view at every moment during the year. The concept of "true and fair" is extremely wide and embraces information not necessarily contained within the accounting records themselves.
- 21 Whether a company is keeping the right kind of accounting records to meet the requirements of the Act is a question of fact to be decided in any particular case. Regard will be had, among other things, to prevailing practice of the time in businesses of the type in question although this consideration will not itself be conclusive.
- 22 What is a sufficient record of stocks within the total picture will depend on the circumstances. The materiality of stock and the extent of stock movements are relevant factors. Continuous stock records can provide adequate information when supported by systematic physical checks. The information may, however, require to be supplemented by judgements with respect to realisable value including times of potential realisation and this may require accounting entries to be made, for example by way of memorandum, as indicated in paragraph 23 below. Continuous records are not essential if the stock position can be assessed with sufficient reliability from other accounting records, for example, the statement of stock held at the previous financial year-end or, in appropriate cases, any interim stocktakings, together with records of subsequent stock movements. Express requirements with respect to stocks held at the end of financial years are contained in section 386(4), and are discussed in paragraph 28 below.

- 23 Provisions for such matters as depreciation, bad debts, impairments and other losses are often made only at the end of an accounting year. The requirement to disclose the financial position with reasonable accuracy at any time during a financial year will normally be satisfied if the basic data is recorded and a procedure exists to be applied to that data, so that when the financial position needs to be ascertained an adequate record is made and retained - for example by way of memorandum - of any expected loss, liability or contingency material to the assessment of the current position. Such a memorandum would then constitute part of the accounting records. Similar considerations also apply to obtaining valuations of certain assets and liabilities – in particular, financial assets and liabilities. The assets and liabilities must be recorded initially but their valuation is a process that can be undertaken within a reasonable time when the financial position needs to be ascertained. What is a reasonable time depends, as noted earlier, on the nature and circumstances of the business. For example, it may be not necessary for a manufacturing company to obtain frequent valuations of, say, its interest rate swaps. However, a financial institution with a very high volume of transactions would need to have frequent valuations of its trading book of interest rate swaps.
- 24 Records made to disclose the current financial position (including any stock records or memoranda) must be retained for the statutory period.

Cash records to be kept

- 25 Section 386(3)(a) requires the accounting records to contain entries from day to day of all sums of money received and expended. Accordingly, the accounting records must contain:
- (1) the dates of transactions;
 - (2) the sums received and expended;
 - (3) the matters in respect of which the receipt and expenditure took place.

As noted above, it is not necessary in all cases for entries to be made instantaneously, although they must be made within a reasonable time.

- 26 It will sometimes be appropriate to record groups of transactions rather than individual transactions (e.g. in the records of the daily cash takings of a shop where a record of individual receipts is not necessary to explain the transactions). Paragraph 29 below sets out the position as regards records of goods sold and purchased.

Assets and liabilities

- 27 Assets and liabilities must be recorded (section 386(3)(b)). Details must therefore be included of all the company's assets and liabilities such as debtors, creditors, properties and plant to a sufficient level of detail to show and explain the company's transactions and to disclose with reasonable accuracy the financial position of the company so that accounts can be prepared.

Stocks

- 28 Section 386(4)(a) requires that where the company's business involves dealing in goods, statements of stock held at each financial year-end are to be part of the accounting records. 'Statements of stock' is taken to mean a summary supporting the amount included in the annual accounts in respect of stock. It is further required, by section 386(4)(b), that any statements of stocktakings supporting the year-end stock summary are to form part of the accounting records. Any continuous stock records used for that purpose, or if stock is taken physically the original stock sheets, are therefore to be treated as part of the accounting records.

Purchases and sales of goods

- 29 Where the company's business involves dealing in goods, section 386(4)(c) requires details of goods sold and purchased, and of individual buyers and sellers, to be recorded. This does not, however, apply to sales by way of ordinary retail trade.

Penalties and disqualification orders

- 30 Under the penalty provisions in section 387 non-compliance with section 386 is a criminal offence by a director (or other officer) who is in default (liable to a maximum of two years' imprisonment, an unlimited fine, or both).
- 31 By virtue of section 9 of, and paragraph 4(a) of Schedule 1 to, the Company Directors Disqualification Act 1986, the extent of the director's responsibility for any failure by the company to comply with section 386 is one of the matters to which the court must have regard on an application for disqualification of a director.
- 32 Companies should note that a failure to keep adequate accounting records may provide a basis for action by prosecuting authorities (as it has in the past in relation to the Proceeds of Crime Act 2002 and may in the future in relation to the Bribery Act 2010). In addition, for those subject to regulatory supervision any such failure may have a significant effect in the context of its regulatory supervision and may lead to intervention by a relevant regulator.

E liz.cole@icaew.com

Copyright © ICAEW 2011
All rights reserved.

This document may be reproduced without specific permission, in whole or part, free of charge and in any format or medium, subject to the conditions that:

- it is reproduced accurately and not used in a misleading context;
- the source of the extract or document, and the copyright of ICAEW, is acknowledged; and
- the title of the document and the reference number (TECH 01/11) are quoted.

Where third-party copyright material has been identified application for permission must be made to the copyright holder.

icaew.com