

## 1 Accounting policies, estimations and judgments (Lecture A667 – 15.51 minutes)

Accounting policies are said to be the ‘backbone’ of an entity’s financial statements. The term ‘accounting policies’ is defined as:

*‘The specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting **financial statements**.’* *FRS 102 Glossary  
**accounting  
policies***

Accounting policies are a critical component of the financial statements because they inform the user as to how amounts are recognised and measured in the financial statements. Any change to an accounting policy (whether voluntarily or because of a change to FRS 102) must be applied retrospectively so that the financial statements are comparable and consistent.

This part of the course does not examine the numerical aspects of accounting policies (e.g. when a change has been made to an accounting policy). Instead, we will be focussing on the disclosure requirements because it is the disclosures that are often flagged up during file reviews or examinations of company accounts.

FRS 102, paragraph 3.17(e) requires an entity to present, as part of its complete set of financial statements, notes, comprising **significant** accounting policies and other explanatory information. The term ‘significant’ has emphasis added because the notes do not need to list every accounting policy of the entity and this is where human intervention is often needed, particularly where automated accounts production software is concerned.

### 1.1 Accounting policies

A company is required to select accounting policies which are appropriate in the circumstances. An example of a typical accounting policy choice would be whether to measure a fixed asset under the cost model (i.e. cost less depreciation less impairment) or apply the revaluation model as permitted in FRS 102, Section 17 *Property, Plant and Equipment*. In addition, some entities which self-construct an asset could choose to capitalise borrowing costs which they incur on loans taken out specifically for the construction to take place; whereas other entities may write off such charges to the profit and loss account. Stock may also be valued using first-in first-out or weighted average cost (but definitely not last-in first-out). It is important where such accounting policy choices are adopted by the entity that they are applied consistently from one reporting period to the next. Any changes in accounting policy must be applied retrospectively; although it is unusual for an entity to change accounting policies frequently; indeed, frequent changes in accounting policy would need to be questioned as to the rationale/objective behind the changes.

Accounting policy choices do not just relate to the recognition and measurement of amounts in the financial statements; they also relate to the presentation of the items in the financial statements. For example, an entity may choose to present depreciation charges within cost of sales or administrative expenses (although entities such as manufacturing companies tend to present depreciation of manufacturing equipment and other production-related assets to cost of sales). Any change in presentation would give rise to a change in accounting policy which, again, has to be applied retrospectively so that the financial statements are comparable and consistent.

## 1.2 Transactions and events not dealt with in FRS 102

In rare situations, a transaction or event may not be dealt with in FRS 102 which would then require management to develop an accounting policy. This is not as straightforward as it sounds because developing the accounting policy must be done in conjunction with FRS 102, Section 2 *Concepts and Pervasive Principles*. In other words, the accounting policy developed by management must provide information which is:

- **Relevant** – it must be relevant to the economic decision-making needs of users; and
- **Reliable** – so that the financial statements:
  - faithfully represent the financial position, financial performance and cash flows of the entity;
  - reflect the substance of transactions, events and conditions rather than legal form;
  - are neutral (in other words free from bias);
  - are prudent; and
  - are complete in all respects.

When management are developing an accounting policy, FRS 102, para 10.5 requires them to refer to, and consider the applicability of, certain sources as follows (in descending order):

- (a) The requirements and guidance in an FRS dealing with similar and related issues.
- (b) Where an entity's financial statements are within the scope of a SORP, the requirements and guidance in that SORP dealing with similar and related issues.
- (c) The definition, recognition criteria and measurement concepts for assets, liabilities, income and expenses and the pervasive principles in FRS 102, Section 2.

FRS 102 (March 2018) does not refer to 'FRC Abstracts' because the FRC have confirmed they will not be issuing Abstracts and have withdrawn those which were in existence.

It is not uncommon for preparers of financial statements under FRS 102 to default to another GAAP when UK GAAP does not deal with a specific transaction, event or other condition in an attempt to develop an appropriate accounting treatment. IFRS does not feature in the hierarchy in FRS 102, para 10.5 but it would be permissible for an entity to refer to IFRS to help in developing an appropriate accounting treatment – although the entity does not have to do this.

### 1.3 Disclosing accounting policies

Once the entity has selected its accounting policies, it must disclose its significant accounting policies which have been used in preparing the financial statements. This does not mean that it discloses **every** accounting policy – only those which are significant. Examples of common accounting policies are shown below but the list is **not exhaustive**:

- Revenue recognition
- Warranty provisions
- Taxation
- Financial instruments
- Research and development
- Intangible assets
- Tangible assets
- Leasing arrangements
- Stock and work in progress
- Provisions for liabilities
- Pensions and other retirement benefits

Those are just a few of the examples of typical accounting policies likely to be found in financial statements, but reporting entities need to make their own judgements as to what significant accounting policies they have and disclose them appropriately.

When disclosing accounting policies, it is important not to just use ‘boiler plate’ policies. A boiler plate policy is one which uses standard wording from the text of an accounting standard without any sort of tailoring so that it is entity-specific. For example: ‘Turnover is stated net of VAT and trade discounts’.

Turnover is often the headline figure in the financial statements and such a policy does not say anything about:

- at what point turnover is recognised (e.g. on despatch of goods);
- how turnover is recognised (e.g. deferred income or income arising from financing transactions);
- if construction contracts are in place, how revenue is recognised in respect of such contracts;

- if there is any deferred revenue, what this represents and when it is recognised; and
- if there is any 'right to return' goods how such items are recorded.

Some significant accounting policies are often generated by the accounts production software but these are not to be relied upon as being completely accurate. Modern accounts production software is not capable of producing entity-specific accounting policies – this is where human intervention is needed to ensure accounting policies are not 'boilerplate'. In some situations it may be necessary to remove the whole software-generated accounting policy and replace it. In other words, do not be afraid to get a red pen and delete the whole policy and replace it with something more specific – this is to be encouraged. However, be careful not to remove accounting policies which are significant and are entity-specific!

An example of an entity-specific revenue accounting policy is shown below:

#### Example – Revenue accounting policy

Turnover is measured at the fair value of the consideration received or receivable, net of VAT and trade discounts. Turnover is also measured net of the estimated value of customer returns and volume rebates.

This is the 'how'

Turnover is recognised on despatch of goods which is the point at which the company transfers the significant risks and rewards of ownership of the goods to the customer. The company retains legal title of the goods until the customer pays, but this does not constitute a retention of the significant risks and rewards of ownership.

This is the 'when'

Amounts received in advance of shipping goods to customers are recognised as deferred income and presented within creditors: amounts falling due within one year.

Other income relates to rent and interest receivable. Rental income is recognised when the company is entitled to receive income based on the contractual agreement in force. Interest income is recognised using the effective interest method.

Audit file inspectors and regulators are interested to see that accounting policies in significant areas of the financial statements are as comprehensive and succinct as possible. Relying wholly on accounts production software systems is not advisable because these will only ever provide a 'basic' non entity-specific policy which might not even be relevant to the client. For example, comprehensive paragraphs about the accounting policy for foreign currency when the entity does not enter into foreign currency transactions would be superfluous and should be removed. Conversely, where the entity has material provisions, the accounting policy in respect of provisions should contain adequate disclosure about what they relate to, how they are initially recognised and how they are subsequently measured.

## 1.4 Key sources of estimation uncertainty and judgements

At the outset it is worth noting that small entities are not required to disclose key sources of estimation uncertainty in their financial statements – although that it is not to say small entities are prohibited from disclosing such uncertainties; they can if they wish. Indeed, FRS 102, para 1AC.3 cross-refers to FRS 102, para 8.6 and states that information about judgements made in applying the small entity's accounting policies may be useful to users of the small entity's financial statements. Professional judgement will be needed by the directors where this is concerned.

Key sources of estimation uncertainty and judgements are often placed adjacent to, or within, the entity's accounting policies (although FRS 102 does not stipulate that they are to be placed here); but this positioning seems sensible.

### Judgements

FRS 102, para 8.6 says:

*'An entity shall disclose, along with its significant accounting policies or other notes, the judgements, apart from those involving estimations (see paragraph 8.7), that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.'*

FRS 102, para 8.6

Revenue recognition is likely to feature quite a lot where judgements are concerned. For example, in concluding that the revenue criteria in FRS 102, Section 23 *Revenue* is met when rectification work may have been required. Other examples include:

- classification of leases between finance leases and operating leases; or
- a sale of goods has been made beyond normal credit terms which constitute a financing arrangement and hence does not give rise to revenue.

The above is not exhaustive.

## Uncertainties

FRS 102, para 8.7 states:

*‘An entity shall disclose in the notes information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the **reporting date**, that have a significant risk of causing a **material** adjustment to the **carrying amounts of assets and liabilities** within the next financial year. In respect of those assets and liabilities, the notes shall include details of:*

*(a) their nature; and*

*(b) their carrying amount as at the end of the **reporting period**.’*

FRS 102, para 8.7

Uncertainties may include the following:

- long-term employee benefit liabilities such as defined benefit pension obligations;
- provisions for liabilities for which litigation is still in progress;
- future technical obsolescence against stock; and
- recoverable amount of fixed assets.

Again this list is not exhaustive.

Where uncertainties are concerned, it is often impracticable to disclose the potential effects of an assumption or other key source of estimation uncertainty at the balance sheet date. Hence, in practice, it is common for most reporting entities to disclose that it is reasonably possible, based on existing knowledge, that outcomes in the next financial year which are different from assumptions used in the financial statements could require a material adjustment to the carrying amount of the affected asset or liability. In all cases, the entity should disclose the nature and carrying amount of the specific asset or liability (or class of assets or liabilities).

There are other areas of FRS 102 which include specific requirements for disclosure which would otherwise be required by FRS 102, para 8.7. An example of this is provisions and contingent liabilities in FRS 102, Section 21 *Provisions and Contingencies* at paragraphs 21.14(c) and 21.15(b).