

Accounting policies, estimates and errors (Lecture A832 – 20.36 minutes)

The issue of accounting policies is one that crops up frequently during file reviews – particularly the disclosure of accounting policies. Inadequate disclosures, or absent disclosures, are some of the main reasons why financial statements are often viewed as containing deficiencies. The main ‘culprit’ is boilerplate accounting policies which tend to be software-generated without any tailoring to the client’s specific circumstances.

The danger with over-reliance on automated accounts production software systems is that it inevitably leads to accounting policies which are either too long, too short or missed out completely. Superfluous accounting policies should be removed along with immaterial accounting policies and those which are significant (or material) should be tailored so they are entity specific.

1.1 FRS 102 requirements

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with accounting policies in Section 10 *Accounting Policies, Estimates and Errors*. FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* deals with the issue in Section 8 *Accounting Policies, Estimates and Errors*.

‘Accounting policies’ are 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

It follows that accounting policies are the choices which an entity makes about which facts it will present and how and where it will present them in the financial statements.

Interestingly, the definition makes references to the ‘principles, bases, conventions, rules and practices applied by an entity’, but does not include accounting estimates which are, in fact, a relevant part of applying an accounting policy and which are usually included in the accounting policy disclosures.

FRS 102, para 10.1 states that Section 10 sets out the requirements for:

- (a) *selecting and applying the **accounting policies** used in preparing **financial statements**;*
- (b) *accounting for **changes in accounting estimates**; and*
- (c) *accounting for corrections of **errors** in prior period financial statements.*

FRS 102, para 10.1(a) to (c)

FRS 102 does not set out the areas to be covered by accounting policies disclosure because these are dealt with in each specific section of the standard.

In terms of restatements, FRS 102, Section 10 distinguishes the situations where an entity restates prior period financial statements for either:

- (a) the correction of a prior period error;
- (b) a change in accounting policy (for which retrospective restatement is necessary);
- (c) restatements due to changes to an accounting estimate (for which no retrospective restatement is necessary).

1.2 Accounting policies and materiality

Accounting standards only deal with material items in the financial statements. The term 'material' is defined as:

*Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the **financial statements**. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.*

FRS
Glossary
material

102

It is generally accepted that materiality has both qualitative and quantitative aspects. FRS 102, para 8.5 states that an entity must disclose its 'significant' accounting policies.

The term 'significant' is not defined in the standard but should be taken to mean material. Hence, only an entity's **material** accounting policies should be included in the notes to the financial statements. The FRC are proposing to change the term 'significant' to 'material' during the current periodic review of FRS 102 which will add clarity.

As noted above, the disclosure of accounting policy information is an issue which is frequently criticised by file reviewers. Often, accounting policies are too lengthy or are irrelevant. This is usually because the user relies too heavily on automated accounts production software systems without tailoring the policies, so they are entity specific. Accounting policies which are required to be disclosed should be concise and relevant to the reporting entity. Just because the accounts production software system may include an accounting policy by default, does not mean it is appropriate or even relevant.

Conversely, accounting policies which are not included by default may need to be included where they are relevant to the entity. Hence, the message here is to not rely too much on accounts production software systems, but to tailor accounting policies so they are entity specific and relevant.

Example – Goodwill written down to £nil

Spring Ltd has included a lengthy accounting policy disclosure concerning goodwill which was fully amortised two years ago.

There is no need to make a lengthy accounting policy disclosure for an intangible asset which has been fully amortised. This can be removed from the accounting policies section of the notes.

Example – Asset under construction

Four years ago, Summer Ltd completed the building of its new head office. The current year's financial statements include a lengthy accounting policy about the way 'Assets under construction' are accounted for in the entity's accounts.

Provided there are no other assets in the course of construction at the reporting date, there is little to be achieved by having a lengthy accounting policy concerning assets under construction. This accounting policy can be removed.

Example – Financial instruments

Autumn Ltd has a number of financial instruments accounted for as both basic and other financial instruments under FRS 102. The accounting policy for financial instruments is shown below:

Financial instruments

A financial asset or a financial liability is recognised when the entity becomes a party to the instrument. Financial liabilities are recognised where there is a contractual obligation to pay cash or transfer other assets to the holder of the instrument and equity is recognised where there is no obligation to transfer cash or other assets.

This accounting policy is inadequate. The accounting policy should describe which instruments are accounted for as basic instruments under FRS 102, Section 11 *Basic Financial Instruments* (e.g. trade debtors, trade creditors, straightforward bank loans etc). It should also describe those instruments which are accounted for as other financial instruments, if appropriate, (such as derivative financial instruments), how transaction costs are accounted for and how fair value gains and losses on non-basic instruments are recognised (e.g. through profit or loss).

While the accounting policy itself need not be excessively lengthy (indeed it is more about quality than quantity), it should be more succinct and entity specific than it currently is.

1.3 Issues that are not dealt with in an FRS

In the rare situation that an FRS does not specifically address a transaction, event or condition, management must use their judgement to develop and apply an accounting policy. This is not as straightforward as it may first seem because FRS 102, paragraph 10.4 states that the policy developed by management must result in information which is:

- (a) *relevant to the economic decision-making needs of users; and*
- (b) *reliable, in that the financial statements:*
 - (i) *represent faithfully the **financial position**, **financial performance** and **cash flows** of the entity;*
 - (ii) *reflect the economic substance of transactions, other events and conditions, and not merely the legal form;*

FRS 102 para
10.4

- (iii) are neutral, ie free from bias;
- (iv) are prudent; and
- (v) are complete in all material respects.

It should be noted that under FRS 102, emphasis is placed on relevance and reliability. The term 'relevance' is defined as:

The quality of information that allows it to influence the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

FRS 102
Glossary
relevance

The term 'reliability' is defined as:

*The quality of information that makes it free from **material error** and bias and represents faithfully that which it either purports to represent or could reasonably be expected to represent.*

FRS 102
Glossary
reliability

For an accounting policy to be reliable, it must reflect the substance of the transaction and not merely legal form. The term 'substance' is essentially the commercial reality of the transaction. For example, currently an asset acquired through a finance lease is capitalised on the balance sheet with a corresponding finance lease creditor because the entity has acquired an asset for use in the business which has been financed through a leasing transaction. In a finance lease, the risks and rewards incidental to ownership of the asset pass to the lessee. If only the legal form of this transaction were considered, the lease would be treated as an operating lease and hence would not be reported on the balance sheet. This accounting treatment is likely to change once the FRC's periodic review is completed as it is expected that most leases will be reported on-balance sheet for accounting periods commencing on or after 1 January 2025.

FRS 102, para 10.4(b)(iii) and (iv) refers to 'neutrality' and 'prudence'. The term 'neutrality' is confirmed as meaning 'free from bias'. In other words, management cannot simply choose a policy because it will achieve a desired outcome, such as a favourable tax treatment.

The term 'prudence' is defined as:

*The inclusion of a degree of caution in the exercise of judgements needed in making the estimates required under conditions of uncertainty, such that **assets** or **income** are not overstated and **liabilities** or **expenses** are not understated.*

FRS 102
Glossary
prudence

Prudence is therefore the exercise of caution when making judgements for various uncertainties to avoid overstating assets or income and understating liabilities or expenses. It does not, however, permit management to deliberately understate assets or income or overstate liabilities or expenses, for example because it improves results or is tax efficient.

The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410) at paragraph 13 brings prudence into the equation, but from a different angle.

Paragraph 13 of Sch 1 to SI 2008/410 states:

The amount of any item must be determined on a prudent basis, and in particular—

SI 2008/410
para 13

- (a) *only profits realised at the balance sheet date are to be included in the profit and loss account, and*
- (b) *all liabilities which have arisen in respect of the financial year to which the accounts relate or a previous financial year must be taken into account, including those which only become apparent between the balance sheet date and the date on which it is signed on behalf of the board of directors in accordance with section 414 of the 2006 Act (approval and signing of accounts), and*
- (c) *all provisions for diminution in value must be recognised, whether the result of the financial year is a profit or loss.*

(c) above was included as part of the amendments to the Companies Act 2006 by The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 (SI 2015/980) and requires a provision for diminution of value to be recognised regardless of whether the result of the financial year is a profit or loss.

GAAP hierarchy

When developing an accounting policy, management must refer to, and consider the applicability of, the following sources in **descending order**:

- (a) the requirements and guidance in an FRS which deals with similar and related issues;
- (b) if the entity is within the scope of a SORP, the requirements and guidance in that SORP which deals with similar and related issues; and
- (c) the definitions, recognition criteria and measurement concepts in respect of assets, liabilities, income and expenses together with the *Concepts and Pervasive Principles* in Section 2 of FRS 102.

Some commentators suggest referring to IFRSs® if FRS 102 does not deal with a specific transaction, event or condition. This would be permissible (indeed paragraph 10.6 of FRS 102 does state that management could consider the requirements and guidance in adopted IFRS). However, as IFRS is not mentioned in the mandatory sources in the GAAP hierarchy, the entity would not be required to follow the provisions in IFRS, if it felt this would be inappropriate to its particular circumstances.

Example – Entity has regard to IAS® 16 *Property, Plant and Equipment*

Wanderers Ltd has an accounting policy of measuring its five owner-occupied buildings under the revaluation model per FRS 102, Section 17 *Property, Plant and Equipment*.

FRS 102 does not deal specifically with the treatment of accumulated depreciation when the buildings have been revalued again. However, IAS 16 does specify two permissible methods in paragraph 35 and hence it would be acceptable to use either one of these methods from IAS 16 when reporting under FRS 102.

When an entity is subject to the requirements of a SORP, it should consider the requirements of that SORP to determine whether it addresses an accounting treatment for a transaction, event or condition that is not dealt with in FRS 102. In situations that a SORP does provide guidance on a specific treatment, but the entity chooses not to apply the SORP's requirements on the grounds that an alternative treatment would be more appropriate, the entity will need to demonstrate that its chosen policy is more appropriate than the SORP's treatment.

In addition, FRS 100 *Application of Financial Reporting Requirements*, para 6 requires that where a non-small entity departs from the provisions of a SORP to which it is subject, it must provide a description of how the financial statements depart from the recommended practice which must include:

- (a) for any treatment that is not in accordance with the SORP, the reasons why the treatment adopted is judged more appropriate to the entity's particular circumstances; and
- (b) brief details of any disclosures recommended by the SORP that have not been provided, and the reasons why they have not been provided.

Small entities are encouraged, but not required, to provide the above disclosures.

1.4 Consistency of accounting policies

In practice, it is rare for an entity to change accounting policies on a regular basis. Indeed, regular changes in an accounting policy would raise the question of why management consider it appropriate to keep changing their policies as retrospective restatement is needed each time a change in an accounting policy is actioned. Frequent changes in accounting policy are not only costly but may also impede on the relevance and reliability of the financial statements.

When management are considering changing a policy, they must consider this carefully. This is because they will have significant difficulty in changing it back in the subsequent year. For example, if a reporting entity had a policy of writing off borrowing costs immediately to profit and loss and then decided to capitalise them, management could not then switch back to a policy of expensing them.

Accounting policies must be consistently applied for similar transactions, other events and conditions. The exception to this rule would be where an FRS specifically requires, or permits, categorisation of items for which different policies may be appropriate.

Consistency is important so that the financial statements can be compared to the prior year and with financial information of other entities. While there is no 'hard and fast' rule which stipulates that accounting policies for all entities in the same industry must be uniform, management may have justifiable reasons for developing entity specific policies which may not necessarily be consistent with the industry in which the entity operates.

The Companies Act 2006 (Sch 1, paras 10(2) and 12) also specifies that accounting policies should be applied consistently within the same accounts and from one financial year to the next, unless there are 'special reasons' for departing from this principle. The Act does not define the term 'special reasons' but such reasons could, for example, be due to the issuance of a new FRS or section in an FRS which triggers the requirement to change an accounting policy.

1.5 Changing an accounting policy

There are two situations when an entity can (or must) change an accounting policy:

- 1) If the change is required by an FRS. This could be as a result of a change to FRS 102 by the FRC which then triggers the entity to action a mandatory change in an accounting policy, or multiple accounting policies. This may be the case following the finalisation of this current periodic review by the FRC in areas such as revenue recognition.
- 2) If the change results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows. This would effectively be a voluntary change in accounting policy and hence accentuates why it would be difficult for management to justify a switch back to the previous policy if things do not go according to plan.

FRS 102, para 10.9 outlines three issues which are **NOT** changes in accounting policies as follows:

- (a) *the application of an accounting policy for transactions, other events or conditions that differ in substance from those previously occurring;*
 - (b) *the application of a new accounting policy for transactions, other events or conditions that did not occur previously or were not material; and*
 - (c) *a change to the cost model when a reliable measure of **fair value** is no longer available (or vice versa) for an asset that an FRS would otherwise require or permit to be measured at fair value.*
- FRS 102 para 10.9(a) to (c)*

Applying a change in accounting policy

FRS 102, para 10.11 outlines certain principles which must be followed when an entity changes an accounting policy or when it elects to follow certain provisions in adopted IFRS as permitted by FRS 102.

A change in accounting policy is applied retrospectively. In other words, the financial statements of previous periods are restated to reflect the revised accounting policy as if the revised policy had always been applied. This is to ensure that the financial statements are comparable (keep in mind that 'comparability' is one of the qualitative characteristics that financial statements must contain according to FRS 102, Section 2 *Concepts and Pervasive Principles*). If a change in accounting policy is not applied retrospectively, the financial statements will not be comparable as the prior year will reflect the old policy, whereas the current year will reflect the new.

If the FRC change FRS 102, any consequential change in an accounting policy is accounted for in accordance with the transitional provisions, if any, which will be specified in the amendment. This is likely to be the case once the FRC complete their current periodic review and issue new versions of UK and Ireland GAAP. Areas such as leasing in FRS 102 are expected to contain significant changes and hence transitional provisions will be included in the new standard to allow entities to reflect the revised accounting treatments.

Changes to an accounting policy are applied retrospectively to comparative information for prior periods to the **earliest date** for which it is practicable. If it is deemed impracticable to determine the individual-period effects of a change on comparative information for the prior period presented, the entity applies the new accounting policy to the carrying amounts of assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable (this may be the current period). A corresponding adjustment is made to the opening balance of each affected component of equity for that period.

Change in accounting policy: borrowing costs

In the financial statements for the year ended 31 March 2021, Frankie Ltd adopted an accounting policy of writing off borrowing costs when it self-constructs an asset to the profit and loss account. In the year to 31 March 2023, management decide to voluntarily change this policy to capitalising borrowing costs as management have concluded that this would result in the financial statements providing reliable and more relevant information about such costs.

This voluntary change in accounting policy should be applied retrospectively for all borrowing costs to the extent that retrospective application is practicable.

Change in accounting policy for inventory

Sunnie Ltd manufactures bedroom furniture and has an accounting reference date of 30 April. Due to changes within the industry, the directors decided to change the method by which they value finished goods at the year end from the first-in first-out (FIFO) method to the average cost method (AVCO). Extracts from the entity's financial statements are as follows:

<u>Value of finished goods</u>	<u>FIFO</u>	<u>AVCO</u>
	£	£
At 30 April 2023		125,000
At 30 April 2022	98,000	112,000
At 30 April 2021	110,000	123,000

The change in accounting policy will be recorded in the financial statements as follows:

At 30 April 2021 (opening balance sheet position of the comparative year)

	£
Dr Inventory	13,000
Cr Retained earnings (P&L reserves)	13,000

Being increase in finished goods as restated under AVCO

At 30 April 2022 (closing comparative year)

	£
Dr Inventory	14,000
Cr Cost of sales (closing stock)	14,000

Being increase in finished goods in prior year as restated

At 30 April 2023 (current year)

	£
Dr Inventory	125,000
Cr Cost of sales (closing stock)	125,000

Being year-end inventory calculated at AVCO

Of course, there may also be tax effects to consider where retrospective restatement due to an accounting policy change has taken place in the financial statements (including deferred tax considerations, where applicable). It follows that when an adjustment is recognised in opening retained earnings, the tax effects should also be accounted for in there as well.

Revaluation of assets

FRS 102, para 10.10A states that the initial application of a policy to revalue assets in accordance with Section 17 or Section 18 *Intangible Assets other than Goodwill* is a change in accounting policy to be dealt with as a revaluation in accordance with those sections, rather than in accordance with FRS 102, paras 10.11 and 10.12.

Therefore, when an entity first adopts the revaluation model for an asset, it need not obtain a retrospective revaluation for the prior year.

Disclosure of a change in accounting policy

FRS 102 requires disclosure of a change in accounting depending on whether the change arises from a mandatory change (i.e. because the FRC have amended an FRS) or a voluntary change.

Mandatory change due to a change in an FRS

Disclose:

- (a) the nature of the change in accounting policy;
- (b) for the current period and each prior period presented (usually just the prior year), to the extent practicable the amount of the adjustment for each financial statement line item affected;
- (c) the amount of the adjustment relating to periods before those presented, to the extent practicable; and
- (d) if it is impracticable to determine the amounts to be disclosed in (b) or (c) above, provide an explanation.

The financial statements of subsequent periods do not need to repeat the above disclosures.

Voluntary changes to an accounting policy

Disclose:

- (a) the nature of the change in accounting policy;
- (b) the reasons why the new accounting policy provides reliable and more relevant information;

- (c) to the extent practicable, the amount of the adjustment for each financial statement line item affected, shown separately:
- (i) for the current period;
 - (ii) for each prior period presented; and
 - (iii) in the aggregate for periods prior to those presented; and
- (d) if it is impracticable to determine the amounts to be disclosed in (c) above, provide an explanation.

As with mandatory changes to an accounting policy, the financial statements for subsequent accounting periods need not repeat these disclosures.

Note also that the statement of changes in equity will also show the effects of retrospective application as an adjustment to retained earnings. Small entities choosing to apply the presentation and disclosure requirements of FRS 102, Section 1A *Small Entities* are encouraged to provide a statement of changes in equity.

When the financial statements of prior periods have been restated for the effects of accounting policy changes, it is good practice (although not a legal requirement) to head the comparative year up 'as restated' so it is clear that there has been a change to the comparative year since those financial statements were originally authorised for issue. Only columns in which figures have changed should be headed up in this way though.

1.6 Changing an accounting estimate

A change in an accounting estimate is an adjustment of the carrying amount of an asset or a liability which results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. A change in an accounting estimate does not result from new information or new developments, hence they are not regarded as a correction of a prior period error.

A 'change in accounting estimate' is defined as follows:

*An adjustment of the **carrying amount** of an **asset** or a **liability**, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of **errors**.*

FRS 102
Glossary
change in accounting estimate

In situations when management may be uncertain as to whether a change is an accounting policy change, or an accounting estimate change, the change is treated as a change in accounting estimate.

A change in an accounting estimate is accounted for on a prospective basis (i.e. no retrospective restatement is required – it is accounted for in the current and subsequent accounting periods).

The most common types of accounting estimates include:

- the useful lives of fixed assets;
- residual values of fixed assets;
- provisions for inventory obsolescence; and
- expected outcome of provisions (such as litigation provisions or warranty provisions).

It must be emphasised that the revision of an estimate will be required if circumstances in which the estimate were originally based change. Such a change is not applied retrospectively as it does not relate to prior periods and is not the same as the correction of an error.

Example – Change in a legal provision

In the financial statements for the year ended 30 April 2022, Dexter Ltd recognised a provision for damages of £25,000. This accounting estimate has been correctly recorded in cost of sales.

The solicitors acting for Dexter confirmed on 30 April 2023 that the damages have reduced to £15,000 due to new evidence presented.

The credit to the profit and loss account of £10,000 (£25,000 less £15,000) should be taken to cost of sales to ensure that the cumulative expense is correctly stated.

Example – Change in depreciation method

During the year to 31 March 2023, Morley Ltd changed the method of depreciating its motor vehicles from 25% reducing balance to four years on a straight-line basis as this revised method better reflects the entity's consumption of the motor vehicles over their useful lives and is consistent with the entity's replacement cycle.

The change in depreciation method is a change in accounting estimate and is accounted for prospectively in the period of the change (i.e. in the current year) and continues in subsequent periods.

Disclosures for a change in accounting estimate

Where the entity changes an accounting estimate, it should provide disclosure of the nature of the change and the effect the change has had on assets, liabilities, income and expense for the current period. If it is practicable for the entity to estimate the effect of the change in one, or more, future periods, the entity is to disclose those estimates.

In addition, Sch 1 to *The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008* (SI 2008/410), para 69(1) states:

Where any amount relating to any preceding financial year is included in any item in the profit and loss account, the effect must be stated.

SI 2008/410,
Sch 1. para
69(1)

1.7 Error correction

Under FRS 102 (and FRS 105) **material** errors are corrected by way of a prior period adjustment.

The term 'errors' is defined in the Glossary to FRS 102 as:

*Omissions from, and misstatements in, the entity's **financial statements** for one or more prior periods arising from a failure to use, or misuse of, reliable information that:*

FRS 102
Glossary **errors**

(a) was available when financial statements for those periods were authorised for issue; and

(b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

FRS 102 identifies the following types of errors (the list below is non-exhaustive):

- effects of mathematical mistakes;
- mistakes in applying the entity's accounting policies;
- oversights or misinterpretation of facts; and
- fraud.

While material prior period errors are corrected retrospectively, FRS 102 does not restrict this requirement to *only* material errors. In practice, an immaterial error would be corrected in the current period.

Errors are distinct from corrections of accounting estimates. A typical estimate would be where a provision for a liability is concerned. The outcome may be higher or lower than previously estimated, but the difference would not be regarded as an error because information was not available prior to the resolution of the issue giving rise to the provision. Similarly, a corporation tax charge for the year may have been estimated and this only becomes final once it has been agreed by HMRC. Any over- or under-provisions would be regarded as a change in accounting estimate and hence would be corrected in the current year.

The correction of a material prior period error is carried out by:

- (a) restating the comparative amount for the prior period(s) presented in which the error occurred; or
- (b) if the error arose before the earliest prior period presented, restate the opening balances of assets, liabilities and equity for the earliest prior period presented.

FRS 102, para 10.22 goes on to clarify that when it is impracticable to determine the period-specific effects of a material error on comparative information for one, or more, prior periods presented, the entity must restate the opening balances of assets, liabilities and equity for the earliest period for which retrospective restatement is practicable and this may be in the current period.

As with changes in accounting policy discussed above, when comparative financial statements have been restated (whether due to error correction or retrospective application of a change in accounting policy), it is best practice to head up the comparative year 'as restated' on each page of the financial statements that have been affected, so the user is aware that the comparative year has been subject to change since those financial statements were originally authorised for issue. Disclosures should also be made where comparative financial statements have been changed.

Disclosures concerning prior period errors

Where material prior period errors have been corrected, disclose:

- (a) the nature of the prior period error;
- (b) for each prior period presented, to the extent practicable, the amount of the correction in respect of each financial statement line item affected;
- (c) to the extent practicable, the amount of the correction at the beginning of the earliest period presented; and
- (d) an explanation where it is not practicable to determine the amounts to be disclosed in (b) or (c) above.

The financial statements of subsequent periods do not need to repeat the disclosures above.

When the prior period figures have been restated, it is good practice to head up the comparative period 'As restated' on each page to notify the reader that there has been an adjustment to the comparative period. There is, however, no specific requirement to do this.