



CHARTERED CERTIFIED ACCOUNTANTS

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Accounting Policies

It is widely understood that a company must adopt accounting policies applicable to the company that meet the objectives of: relevance, reliability, comparability and understandability at financial statement level. Surprisingly, recent reports have revealed companies whose accounting policies, as disclosed in the financial statements, bear no resemblance to how such transactions and events have been accounted for in the financial statements. This can often have detrimental impacts during the course of any regulatory review by the various professional bodies.

This article aims to clarify the purpose of accounting policies, how to account for changes in the accounting policies as well as looking at a recently debated subject concerning the interaction of the principles in the accounting policy standard to that of FRS 15 '*Tangible Fixed Assets*'.

Accounting policies are dealt with in the provisions of FRS 18 '*Accounting Policies*', FRSSE (effective April 2008) in section 2 and IAS 8 '*Accounting Policies, Changes in Accounting Estimate and Error*'.

Accounting policies are the principles, bases, conventions, rules and practices which are applied by a reporting entity that specify how transactions and other events are accounted for in the financial statements and a company is required to disclose all of its material accounting policies within the notes to the financial statements.

It is not uncommon to look at a set of financial statements to see that a company might disclose a foreign exchange policy, when in fact the company might not enter into overseas transactions. It is worth mentioning at this point in the article, that such accounting policies do not require disclosure if they are not relevant to an entity. In addition, if a company does not have any material amounts of deferred taxation, then there is little point in disclosing a half-page policy in the notes to the financial statements about how deferred tax is recognised. Those practitioners using accounts production software should 'tailor' the accounting policies to the client concerned.

Accounting policies

A company must adopt accounting policies which will allow its financial statements to give a true and fair view. In addition, the accounting policies which a company selects must also be consistent

with the provisions of the accounting standards, including Task Force Abstracts and the Companies Acts.

Under the provisions in FRS 18, company directors must regularly review the accounting policies to ensure that they remain the most appropriate to the company's particular circumstances and ensure that they allow the financial statements to give a true and fair view. Where the accounting policies are considered no longer appropriate to the company's circumstances and which would result in the financial statements failing to give a true and fair view, then the accounting policies must be changed.

Changes in accounting policy

Changes in accounting policy must be applied retrospectively; that is applying the change to the earliest period reported in the financial statements. Typically, financial statements will show the current year and the comparative year. Any changes to accounting policies must be applied to the comparative year, the opening profit and loss account balance restated and the comparative year clearly headed up 'as re-stated'. In addition, disclosure should also be made of the change to a company's accounting policy including:

1. A brief explanation of why each new accounting policy is thought more appropriate.
2. Where practicable, the effect of a prior period adjustment on the results for the preceding period.
3. Where practicable, an indication of the effect of a change in accounting policy on the results for the current period.

Where it is not practicable to make the disclosures in 2 or 3 above, then a company should disclose that fact together with reasons.

Examples of changes to accounting policies are:

- Reclassification of various costs from administrative expenses to, say, cost of sales.
- Changing from historical basis of financial reporting to fair value reporting (very rare).
- Changing the basis of stock valuation from first-in first-out to weighted average.
- Capitalising finance costs in the construction of a fixed asset instead of charging the finance costs to the profit and loss account.
- Translating a foreign subsidiary's results using the average rate, when the company previously adopted the closing rate.

Changes in estimation technique

Changes in estimation technique are also covered in FRS 18. Any changes to estimation technique are not accounted for in the same way as changes in accounting policy. Instead, any changes in estimation technique are accounted for prospectively i.e. going forward.

Figure 1

A company changes its method of depreciation of its motor vehicles from 25% reducing balance, to 3 years straight line.

This is not a change in accounting policy, depreciation is simply a 'best estimate' of the asset's useful economic life – the original 'cost' of the asset is still being consumed over the expected useful life of the vehicles, albeit at a faster rate.

The purpose of estimation techniques is essentially to arrive at a monetary amount which corresponds to a particular measurement basis. In recognition of this principle, all estimation techniques adopted by a company must be reliable but should also take account of materiality and cost/benefit considerations.

Common problems with accounting policies

As mentioned earlier in the article, it is not uncommon for accounting policies to be disclosed within a set of financial statements and for them to be either incorrect or inappropriate to a company. For example, disclosing the company's accounting policy for hire purchase and leasing when, in fact, the company does not have any assets subject to HP or leasing.

In addition, dealing with accounting policy changes also seems to cause problems. If the directors feel that (for example) depreciation charges are better reflected within cost of sales as opposed to administration expenses, then the prior year should also be adjusted to reflect this change in accounting policy. By not applying this change retrospectively, the profit and loss account will be distorted because the current year will show higher cost of sales, thus reduced gross profit and reduced gross profit margins and the comparative year will show a disproportionately high value of administrative expenses in respect of depreciation.

Preparer's of financial statements should also ensure that the financial statements account for transactions and events in accordance with a company's accounting policies. For example, if the company has a (very rare) policy of discounting its deferred tax balance to present day values, then the accountant should ensure that they do this. Recognising an undiscounted deferred tax balance would contravene the company's declared accounting policy in this regard.

Figure 2

In 2007, a company decided that it was going to switch from the depreciated historic cost of measuring its buildings to the revaluation model, as permitted in FRS 15 'Tangible Fixed Assets'.

In 2009, the directors decided that they no longer wanted to use the revaluation model in measuring their buildings and decided that they should switch back to the depreciated historic cost model.

FRS 18 says that an entity's accounting policies should be reviewed regularly to ensure that they remain the most appropriate to its particular circumstances for the purpose of giving a true and fair view. Clearly, in 2007 the directors in Figure 2 decided that the depreciated historic cost would no longer give a true and fair view, which resulted in a change to the revaluation model.

Fair values would always be more reliable than depreciated historic cost and therefore in this respect, it would not be possible to switch back to the depreciated historic cost model on a material class of asset such as buildings.

This article has looked at the key aspects of accounting policies and changes in such as well as what constitute a change in estimation technique and a change in accounting policies. Accountants should ensure that the financial statements are prepared in accordance with a company's declared accounting policies as well as ensuring that any accounting policies which are either immaterial or irrelevant to the reporting entity are not disclosed.

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