chapter five

section one

Accounting concepts, policies and standards

Why do we need concepts and rules?

Fundamental accounting concepts

Fundamental concepts in operation

Accounting policies

Checklist

Why do we need concepts and rules?

The great majority of events and transactions are very clear and can be quantified by a very specific amount (of money). The event will clearly indicate whether there is a change in assets/liabilities/income or expense.

For example, if a manufacturer sells equipment which costs 2,700 to manufacture for 4,000 cash, then there is a decrease in equipment finished goods stock of 2,700 an equal P & L cost, sales of 4,000 and an increase in cash of 4,000. The reported profit of 1,300 and asset position in the balance sheet will be indisputably correct.

However, consider if the equipment which cost 2,700 to manufacture was sold to an overseas customer who pays 1,000 by immediate bank transfer and will pay the balance of 3,000 in three months time after delivery and satisfactory performance. The overall figures are as above and the resultant profit and balance sheet figures should be the same.

From today's viewpoint the entire 2,700 stock has gone, replaced by cash of 1,000 and a 3,000 debtor – but is this a 'good' asset – will the customer pay?

It could be argued that income is earned in two stages 1,000 sales today with 3,000 sales in three months, this being confirmed by the customer accepting the item as in working order and paying! Maybe costs would have to be apportioned accordingly as well?

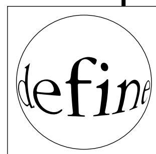
Such situations frequently arise in business and there is thus the need for clear rules as to how to account for and disclose transactions. It is important to realise that there is much convention based on experience, as to how items are disclosed. Although there have been abuses of the conventions with resulting scandals and frauds which have hit the headlines, most businesses are in a position to, and do, report clearly and fairly.

Some accountants and accounting authorities believe that it is possible to be highly prescriptive and set rules - accounting standards and guidelines for every situation. In the UK and in the accounting standards issued by the

International Accounting Standards Board (IAS), the view is that rules should be general in nature, leaving the fine detail of rule setting to business entities.

Fundamental accounting concepts

There are generally accepted to be only four fundamental accounting concepts, although some academics and accountants suggest that these are too few and thus come up with more. These are really sub divisions or developments of the four fundamental concepts.



The four fundamental concepts

1 Going concern

The preparer (and auditor) of the accounts should consider and check whether or not the enterprise is likely to continue in operational existence for the foreseeable future. This means in particular that there is no intention or necessity to liquidate or curtail significantly the scale of operations and thus the P & L account and balance sheet will not be materially affected. For example, if a business which manufactures a product line on specialised equipment decides to cease manufacturing the product, the equipment will very likely cease to have and hold the value it did when this part of the business was 'a going concern'.

The 'going concern' concept also requires the preparer (and auditor) to consider and check that the business is likely to have cash/bank resources sufficient to remain in business for the foreseeable future – 'foreseeable future' is considered by UK auditing standards to be at period of at least 12 months beyond the date of signing the latest year end accounts.

2 Accruals or matching concept

Revenue and costs should be accrued (that is, recognised as they are earned or incurred, not as money is received or paid), matched with one another so far as their relationship can be established or justifiably assumed, and dealt with in the P & L account of the period to which they relate; with the proviso that where the accruals concept is inconsistent with the 'prudence ' concept the latter will prevail.

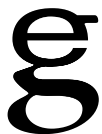
3 Consistency

There should be consistency of accounting treatment of like items within each accounting period and from one period to the next.

4 Prudence

Revenue and thus profits should not be anticipated, but should be recognised by inclusion in the P & L account only when realised either in the form of cash or of other assets which can be realised as cash with reasonable certainty. Provision should be made for all known liabilities (related to expenses and present or future losses) whether the amount of these is known with certainty or is a best estimate in the light of the information available.

Fundamental concepts in operation

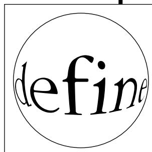


Referring back to the original example – how should the 3,000 (deferred) sale to the overseas customer be accounted for? The fundamental concepts only give guidance. The two which are specifically pertinent in this case are the accruals and prudence concepts. From a timing (accruals or matching) point of view is it correct to recognise the sale today? Probably yes, stock has been sold (there should be paper work, a contract or at least an order and sales invoice). The further matter to consider is the quality of the 3,000 debtor – will the customer have a reason or find an excuse not to accept the equipment? Will the customer pay? Is it

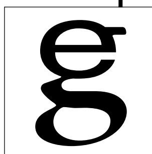
prudent to accept the 3,000 as an asset. It may be necessary (prudent) to make some provision against the debtor not paying. This does raise the question as to why goods were sold to this customer in the first place!

The fundamental concepts are the basis from which detailed accounting policies are developed. Two frequently met situations where accounting policies are required are – depreciation of fixed assets and valuation of stock/ inventory and work in progress (WIP).

Depreciation



The exercise of depreciating a fixed asset is the operation of the matching concept. By definition a fixed asset is one that lasts for and is in use in more than one accounting period. It is a long-term asset in the balance sheet. The fixed asset is used or consumed over its life and loses value. If nothing is done about recognising the use, the asset will still be shown in the balance sheet with value – it is a 'phoney' asset. The exercise of depreciating assets is one of **matching** their use over their expected life. A simple example of the arithmetic of depreciation was shown on page 140 in Chapter 4 Section 2.



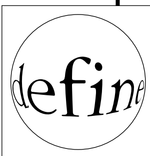
fixed asset cost 15,000

zero value at end of 5 years

expected useful life 5 years – assumed to be used an equal amount each year of its working life

annual depreciation charge 15,000/5 = 3,000 per year

The cost of the asset can therefore be matched with the benefit/income arising from using it.

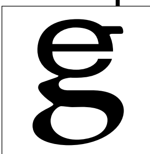


Stock/WIP valuation

The exercise of counting or taking stock at the end of an accounting period is again the **matching** concept in action. A simple example of the arithmetic of the stock adjustment was shown on page 140 in Chapter 4 Section 2.

materials purchased in the period	8,500
stock held at the end of the period	800
therefore materials consumed into products in the period	7,700

It would be incorrect to show all the materials purchased as a cost of production, those not taken into production or sold are an asset of the business, not a cost. This is of course assuming the stock does hold value and can be used or realised in the next accounting period.



A question arises over what figure to use for the value of stock? In the simple example above the conventional and normally correct figure is the cost of the remaining stock or WIP should be valued at what it cost.

However, if for some reason the stock on hand had deteriorated or could be replaced at a (permanently) much lower price, then the stock should be written down to its net realisable value (nrv). This is the **prudence** concept in operation.

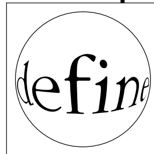
It is obvious that if the stock has deteriorated then it will not realise so much when ultimately sold. Equally if it was possible to purchase replacement stock at a much lower price then the stock held will not realise so much or maybe even its original cost on ultimate sale.

Much can be made of what is the cost of stock or WIP. If stock items are purchased piecemeal over time then what is the cost of the stock at the period end? In the UK it is generally accepted that stock should be accounted for and therefore valued on a 'first in first out basis' (FIFO), that is remaining stock is the most recently purchased. This seems

entirely reasonable as stock will be at an up to date cost. Also it is likely that the oldest stock will be sold first.

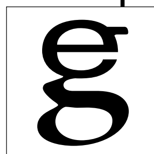
With the possible range of figures, and particularly opinions as to what the cost or ultimate selling price might be, it will be appreciated that stock/WIP valuation is a critical area for preparers of accounts and auditors. Stock valuation is often a highly subjective area.

Accounting policies



The fundamental accounting concepts are used as a basis for preparing the rules or accounting policies to be applied when preparing a set of accounts.

For many businesses there is no great issue over the use of the fundamental concepts and rules – accounting policies based thereon. A small trading company would typically have the following accounting policies, often as the first note to the accounts.



XYZ Limited

Notes to the accounts for the year ended 31 March 1997

Accounting policies

Accounting convention

The accounts are prepared under the historical cost convention.

This simply means that the figures, particularly balance sheet assets, are based on what the respective item cost, there has been no revaluation of any item. This is quite correctly prudent for current assets, but may be misleading for tangible fixed assets and thus a policy of revaluing land and buildings may be adopted.

Turnover

Turnover represents the invoiced amounts of goods sold and services provided net of value added or sales tax.

This makes it clear that the sales income shown is that of the business and does not include the VAT or sales tax element of sales which has to go to the government.

Depreciation

Depreciation is provided on all tangible fixed assets at rates calculated to write off the cost or valuation of each asset over its expected useful life as follows:

Motor vehicles	*4 years*
Fixtures and Fittings	*10-50 years*
Electronic Equipment	*3 years*

This sets out the rates (not highly detailed) by which fixed asset cost is spread over time – the accruals or matching principle.

Stocks

Stocks are stated at the lower of cost or net realisable value.

This states that stocks are valued at what they cost, not revalued in any way, further if the stock is now not worth so much – it has deteriorated or 'gone off' it is written down to the net amount which should be realised – the prudence concept.

There is really nothing very deep or controversial in the above and these policies are typical for a small business. Not all business operations will be simple and more detailed, specific policies will be required. Again, in the published accounts the meaning and effect of policies should be clear.

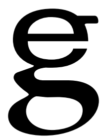
Read the accounting policies

The reason for reviewing the accounting policies is that the figures in the accounts can only really be properly interpreted if the base upon which they are prepared is known. With the majority of figures there will be no problem, but there may be figures which are prepared and disclosed in an unconventional manner. The policies must be reviewed before looking at the figures.

Accounting policies should relate to the business (be appropriate for the business)

What policies are needed, what are appropriate? You do not need to be an accountant to appreciate that policies should be appropriate to the type of business being carried out.

For example, from a telecommunications company accounts as illustrated earlier.



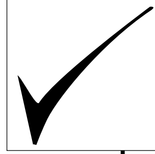
Engineering stores

Most engineering stores items are used in the construction of new plant and the remainder for maintenance. When issued these stores are charged to the cost of the specific plant or to the profit and loss account as appropriate. They are stated at cost, less a provision for excess and obsolete items.

A policy which clearly states that costs of equipment is correctly allocated as asset or cost when taken from stores. Also stores are valued on a prudent basis.

Further and more detailed analysis of accounting policies can be found in Section 2

Checklist



- ✓ Income and expenses should be matched.
- ✓ Figures should be prepared and disclosed in a prudent and consistent manner.
- ✓ Accounting policies should be studied before the figures.
- ✓ Accounting policies should relate to the business.

chapter five

section two

Accounting concepts, policies and standards

Accounting standards

Detailed accounting policies

Developing accounting policies

A contractor

A travel agency

Creative accounting

Creative accounting illustration

Checklist

Accounting standards

It is not the place of this text to give a history of accounting or accounting standards nor to carry out a comparative study of the standards to be found in different countries. Set out below is a brief background to the UK and International Accounting Standards (IAS) with a précis of the purpose of the principal standards.

Background to accounting standards

The setting of standards is a comparatively recent event – in the US and UK in the 1950s there were no formal standards and in fact it was not until the 1970s that Britain had its first standards.

There was much convention as to the bases, layout and disclosure of figures and statements but company law did not prescribe the manner in which figures should be disclosed or statements presented.

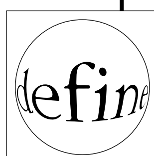
It should be noted that the UK and US approach (based on a common law background) differs from say the French approach (based on a code law system – the Napoleonic Code). The disclosure requirements in various countries are affected by many factors, the legal system as mentioned above, the history of trade development and the economic structure – free enterprise versus centrally planned.

With the dominant position of US companies and with the internationalisation of trade, the US standards (GAAP – Generally Accepted Accounting Practices) are the greatest in number and detail and most frequently followed. Other countries, particularly the UK, developed their own standards (many being similar in principal to the US standards) and contributed to the setting up of a body to produce international standards which will meet the needs of each participating country and, more importantly, the appropriate national stock exchange. The independent body, comprising members from national accounting bodies, hopes to have a complete set of acceptable standards in place in 1998.

Legal force of standards

The Companies Act 1985 clearly implies that accounts should be prepared in accordance with accepted accounting standards and Schedule 4 to the Act describes the use of fundamental accounting concepts. Accounting standards are issued by the Accounting Standards Board in the UK and are the 'law' as far as any qualified accountant or authorised auditor is concerned. There is continuing debate over whether or not standards should be set by and their use governed by the profession. However, it is fair to say at the present time that UK standards are impartially prepared and properly monitored in use.

The need to follow standards may be enshrined in law but possibly the more important need is to meet stock exchange requirements – if there is inadequate or improper disclosure, a company's shares will not be listed on a recognised stock market. It is also the force of the markets which is behind the current drive to have a set of International Accounting Standards (IAS) agreed. If companies wish to raise new equity capital, they will have to comply with disclosure requirements demanded by recognised stock markets.



Purpose and content of principal accounting standards

The purpose of the UK, US and international standards is above all to bring consistency of reporting. Other reasons are to ensure 'full' disclosure, that is, no hidden or undervalued assets or, more importantly, hidden or understated liabilities. There is also the need for standards to assist in disclosing transactions where there may be several interpretations of events. A general point of principal is that with disclosure of figures and related notes there should be an emphasis on 'substance over form', that is, the commercial reality of transitions and resulting assets/liabilities should be shown rather than that required

by a strict interpretation of (the minimum) legally required disclosure.

It is beyond the scope of this text to précis or even list all extant UK or international standards. If a reader has a particular problem with disclosure of balance sheet or P & L items, reference to UK or international standards is quite likely to reveal that there is a standard covering the item. For example, there are several standards covering tangible fixed assets, investment fixed assets, stocks and work-in-progress. There are also standards covering the fundamental concepts and balance sheet and P & L disclosures.

Detailed accounting policies

Generally the published accounting policies are glib – there is not the space to go into great detail and it may be that too much detail would confuse the average reader of the accounts.

As stated in Section 1, most accounting policies are conventional and this is another reason why many published notes may appear glib. On reviewing policies what you are looking for is the unusual, those that seem out of line with the type of business apparently being carried on or which are 'loose' – that is permit a wide range of interpretations.

Set out below are accounting policies notes taken from the published accounts of various companies in different industry sectors.

Each note is followed by a commentary on what it means and highlighting critical points, if any.

Construction company

Provision is made at current prices for the cost of restoring land from which minerals have been extracted.

The liability to reinstate land used for quarrying is being acknowledged. The question to be asked would be, 'Is adequate provision being made?' Current prices are being used – will the standards of reinstatement not be higher by the time the work has to be carried out?

Long-term contracts

Amounts recoverable on contracts, which are included in debtors, are stated at cost plus attributable profit less any foreseeable losses. Payments received on account of contracts are deducted from amounts recoverable on contracts. Such amounts which have been received and exceed amounts recoverable are included in creditors.

This policy follows UK SSAP 9. Profitable work done on projects is considered as sold and thus a debtor in the balance sheet. If the cost of work done and to be done is in excess of likely sales, the expected loss is provided for now. The cash received from the customer is netted against the debtor in the balance sheet or, if in excess (advance payments from the customer), the payments in advance are shown in the balance sheet as a liability – due back to the customer. This is obviously prudent.

Airport owner and operator

Fixed assets

1 Investment properties

Fully completed properties let to, and operated by, third parties and held for long-term retention, including those at airport locations, are accounted for as investment properties and valued at the balance sheet date at open market value. All investment properties are revalued annually and by external valuers at least once every five years. Any surplus or deficit in revaluation is transferred to revaluation reserve except that deficits below original cost which are expected to be permanent are charged to the profit and loss account.

Profits or losses arising from the sale of investment properties are calculated by reference to book value and treated as exceptional items.

In accordance with SSAP 19, Accounting for Investment Properties, no depreciation is provided in respect of freehold or long-term leasehold investment properties. This is a departure from the Companies Act 1985 which requires all properties to be depreciated. Such properties are not held for consumption but investment and the directors consider that to depreciate them would not give a true and fair view. Depreciation is only one amongst many factors reflected in the annual valuation of properties and accordingly the amount of depreciation which might otherwise have been charged cannot be separately identified or quantified. The directors consider that this policy results in the accounts giving a true and fair view.

Those properties defined as investment properties (rather than being tangible fixed assets used directly by the company) are being regularly revalued (up or down) with periodic independent back-up to the valuations – this is simply good business and accounting practice.

Company law picked up the point that tangible fixed assets do wear out or are consumed and thus requires that they be depreciated. SSAP 19 acknowledges that investment properties are considered as investments and not used directly by the owning company and therefore depreciation is considered inappropriate and the true and fair view is given by not depreciating.

2 Operational assets

Terminal complexes, airfield assets, plant and equipment, fixtures and fittings and group occupied properties are stated at cost less accumulated depreciation. Assets in course of construction are stated at cost less provision for permanent diminution in value and assume that projects in early planning stages will receive consents necessary to achieve a successful outcome. Where appropriate, cost includes interest, own labour and associated overheads.

Other tangible fixed assets are stated at (historical) cost. This includes capitalised interest and the cost of the company's own labour and associated overheads. The questions to be asked would be, 'How much interest is capitalised?' this can usually be found in a note to the accounts; 'How much 'own work' has been capitalised and what is the amount of overhead included in this cost?'

3 Depreciation

Depreciation is provided on operational assets, other than land, to write off the cost of the assets by equal instalments over their useful lives as follows:

Fixed assets lives

Terminal building, pier and satellite structures	*50 years*
Terminal fixtures and fittings	*5-20 years*
Airport plant and equipment including runway lighting and building plant	*5-20 years*
Tunnels, bridges and subways	*50 years*
Runways, taxiways and aprons	*up to 100 years*

Transit systems:	
– rolling stock	*20 years*
– track	*50 years*
Motor vehicles	*4-8 years*
Office equipment	*5-10 years*
Short leasehold properties	*over the period of the lease*

Major periodic maintenance expenditure on runways, taxiways and aprons is charged to the profit and loss account as incurred.

A policy stating the method of depreciation – straight line and giving a fairly detailed indication of the lives of the tangible fixed assets.

Properties held for resale

Properties held for resale are stated at the lower of cost and net realisable value.

This policy indicates that these properties are really treated as trading stock.

Interest

Interest payable is charged as incurred, except when the borrowing finances tangible fixed assets in the course of construction. Such interest is capitalised once planning permission has been obtained and a firm decision to proceed has been taken until the asset is complete and income-producing and then written off by way of depreciation of the relevant asset.

This policy reiterates the practice of capitalising interest borrowings related to capital expenditure on major new fixed assets.

The oil corporation

Environmental conservation and site restoration cost

Liabilities for environmental conservation are recorded when it is probable that obligations have been incurred and the amounts can reasonably be estimated. These liabilities are not reduced by possible recoveries from third parties and projected cash expenditures are not discounted.

Site restoration costs that may be incurred by the Corporation at the end of the operating life of certain of its facilities and properties are reserved rateably over the asset's productive life.

The liabilities for environmental related costs is being acknowledged. The charge is being made rateably (proportionally) over the life of the asset (to be decommissioned). The question which must be asked is, 'Is adequate provision being made?' What will the environmental standards be when the site/plant is finally decommissioned?

Supermarket chain plc

Basis of financial statements

The financial statements have been prepared in accordance with applicable accounting standards, under the historical cost convention, and are in accordance with the Companies Act 1985.

The historical cost basis is being used – figures are at cost or net realisable value if lower. There is no revaluation of properties. This can be compared with the airport owner and operator policy on page 158.

Stocks

Stocks are valued on the basis of first in first out at the lower of cost and net realisable value. Stocks in stores are calculated at retail prices and reduced by appropriate margins to the lower of cost and net realisable value.

Stocks are correctly being valued at cost or net realisable value on first in first out basis (FIFO), that is, it is assumed that the oldest items are sold first. Let's hope so! Strictly speaking, stock should be counted and valued at invoiced (purchased) cost. This would be quite impractical for a supermarket business – the retail price of merchandise is clearly known as are very precise margins by which the retail prices may be reduced to cost.

A telecommunication company

VII Intangible assets

Broadcasting licences, which are held in an associated undertaking, are stated at historical cost. No amortisation is provided on these assets, but their value is reviewed annually by the directors and the cost is written down if permanent diminution in value has occurred.

The intangibles are not owned directly by the company or a subsidiary but rather in an associate. The value in the associate's accounts is historical cost or net realisable value – this is prudent, but the question to be asked is, 'Are these intangibles worth considerably more than historic cost?'

As an example of what is meant, set out below are the accounting policies of the hotel chain, followed by a summary explanation of what they mean. Some of the policies are quite detailed and the meaning may be obscure, for example, consolidation and deferred tax. At this stage accept that these do just explain normal accounting convention. If you encounter unclear wording, hopefully you should be able to get an accountant to clarify the situation!

Question

Review the following accounting policies – which one(s) require more explanation?

Accounting policies

1 Accounting convention

The accounts have been prepared under the historical cost convention as modified by revaluations of certain properties and investments, and in accordance with the Companies Act 1985, as amended by the Companies Act 1989, and applicable Accounting Standards.

2 Basis of consolidation

a) **Acquisitions and disposals.** The Group balance sheet includes all the assets and liabilities of subsidiary undertakings including those acquired during the period. The Group profit on ordinary activities after taxation includes only that proportion of the results arising since the effective date of control, or in the case of undertakings or interests disposed of, for the period of ownership.

b) **Associated undertakings.** The Group profit on ordinary activities before taxation includes the Group's proportion of the profits and losses of associated undertakings and the taxation charge includes taxation on those results.

c) **Joint ventures.** The results and net assets of joint ventures are fully consolidated where the Group has a participating interest therein and either manages them on a unified basis with certain subsidiary undertakings or actually exercises dominant influence over them.

d) **Goodwill.** Goodwill represents the difference between the costs of acquisition and the fair value of the separable net assets acquired. Goodwill is written off or credited to reserves in the year of acquisition.

e) **Overseas undertakings.** The Group accounts are prepared in accordance with UK generally accepted accounting principles.

3 Sales

Sales represent the amounts receivable for services provided and goods sold, excluding inter-group sales, VAI and similar sales taxes.

4 Interest, internal professional fees and preopening expenses

Interest on capital employed on the construction and major development of hotels and restaurants and internal professional costs incurred until these enterprises start to trade may, if appropriate, be capitalised as part of the costs of construction. In addition, pre-opening and development expenses incurred up to the start of full trading may, if appropriate, be deferred and written off over five to ten years.

5 Fixed assets

a) **Property values.** Freehold properties and leasehold properties with twenty years or more to run at the balance sheet date are revalued at regular intervals and the resultant valuation is included in the balance sheet. When the unexpired term falls below twenty years, no further revaluations are carried out.

b) **Revaluation reserve.** The difference between the resultant valuation and historic cost is recorded in the revaluation reserve to the extent that the

valuation exceeds historic cost on a property by property basis. Any permanent diminution in the value of fixed assets is charged to the profit and loss account as appropriate after making any associated adjustment)t to the revaluation reserve.

c) **Disposals.** Where the Group disposes of fixed assets in the normal course of trading, the profit or loss arising is included in the profit on ordinary activities before taxation. The profit or loss on disposal is calculated by reference to the revalued amount.

d) **Depreciation of properties.** In accordance with normal practice in the UK hotel industry, no depreciation is provided on freehold properties or properties on leases with twenty years or more to run at the balance sheet date or on integral fixed plant. It is the Group's practice to maintain these assets in a continual state of sound repair and to extend and make improvements thereto from time to time. Accordingly the Directors consider that the lives of these assets and residual values (based on prices prevailing at the time of acquisition or subsequent valuation) are such that their depreciation) is insignificant. All leasehold properties held for less than twenty years are amortised over the unexpired term.

e) **Depreciation of other assets.** Depreciation is provided on all other assets on a straight line basis over ten to fifteen years for plant and machinery, four to ten years for furniture and equipment and up to five years for information technology software and hardware.

6 Leases

Finance leases are those which transfer substantially all the risks and rewards of ownership to the lessee. Assets held under such leases are capitalised as tangible fixed assets and

depreciation is provided where appropriate. Outstanding finance lease obligations which comprise principal plus accrued interest, are included within creditors falling due after more than one year. The finance element of the agreements is charged to the profit and loss account over the term of the lease on a systematic basis. All other leases are operating leases. The rentals on such leases are charged to the profit and loss account as incurred.

7 Stocks

Stocks are stated at the lower of cost and net realisable value.

8 Pensions

The cost of providing pensions and other post retirement benefits is charged against profits on a systematic basis with pension surpluses and deficits arising allocated over the expected remaining service lives of employees.

9 Deferred taxation

Provision is made for deferred taxation arising from timing differences between profits as computed for taxation purposes and profits as stated in the accounts to the extent that the liability will be payable in the foreseeable future.

10 Foreign currencies

Overseas trading results are expressed in sterling at the average rates of exchange ruling during the financial year. Overseas net assets and UK loans denominated in foreign currencies are expressed in sterling at the average rates of exchange ruling during one week prior and one week subsequent to the balance sheet date or contracted sales where appropriate. The effect of currency movements on assets and liabilities is taken to reserves.

Answer

Review of the hotel chain's accounting policies

1 *Accounting convention*

Historical cost basis. This means that the accounts are prepared with historical figures, that is the figures arising whenever a transaction occurred. This is the accepted convention as it would be unrealistic to continually revalue, say machinery or stocks. In any event many figures such as debtors, creditors and loan balances will not change just because of the passage of time.

However, it is generally recognised as good practice to revalue properties. Properties have tended to significantly increase in value over the years. Normal commercial property can usually be valued with a fair degree of accuracy and it thus makes sense to show an up to date value – there is more worth for the shareholders and more security for borrowing purposes.

2 *Basis of consolidation*

These notes set out the general basis on which the accounts of all the companies in the group are drawn together – consolidated.

d) Goodwill. This indicates a prudent approach in that any premium paid on acquisition of a subsidiary is written off immediately. In 1998 a new accounting standard FRS 10 now requires goodwill to be written off over a number of years (normally 20 max.).

3 *Sales*

A very conventional policy. Only sales to third parties are included net of VAT and sales taxes which belong to the appropriate revenue authority.

4 Interest, internal professional fees and pre-opening expenses

This is the interesting one! What some might consider normal costs incurred in developing a business are possibly included as part of fixed assets, rather than being charged to the P & L account. The use of words like 'may', 'if appropriate' 'full trading' require further explanation. Exactly how much is being deducted from costs and classified as assets? Are these costs real assets?

5 Fixed assets to ten foreign currencies

These are all quite conventional policies, but for 5(d) strictly speaking business, as opposed to investment properties should be depreciated.

Developing accounting policies

Accounting policies within the company

There is obviously the over-riding need to comply with published accounting standards. In doing so there will often be the need to set out in some detail how events, transactions and the related figures are compiled and reported internally as well as in the published accounts.

Detailed accounting policies, accounting instructions and manuals

All companies, even the smallest, should have written accounting policies available for all those who are expected to take responsibility for reports and figures. This is not a matter of bureaucracy, but rather to ensure that everyone who deals with and has to act on figures knows on what they are based.

It often seems a waste that all the thought and effort by accountants which has gone into devising appropriate

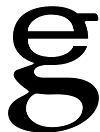
detailed accounting policies is not more widely used or at least explained to the directors and managers of companies.

Properly formulated and actioned practical accounting policies can assist in the proper running of the business, also bringing consistency to resulting actions.

Even for small companies it may be useful to review and commit to writing accounting policies in some detail – they often tie in with the accounting procedures, routines and controls which ought to be found in any business. There is also a link with ISO 9000 certification.

Set out below are two short extracts from accounting manuals. It is impracticable to give examples of all the detailed policies which would be required for all types of business. These paragraphs are meant as an illustration of what should exist in any organisation and of which many managers should be more aware.

A contractor



Sales profit recognition

Definition of types of sale

The accounting policy reflects the fact that all XYZ plc projects can be defined as being either

A **Direct Sales Projects (DS)**

or

B **Earned Value Projects (EV)**

Accounting Policies

A D S Projects

The policy is to recognise a sale and thus the profit when the project work is invoiced.

Project work will only be invoiced when clear deliverables can and will be acknowledged by the customer. At this

point the sales value is clearly known and costs relating to the sale can fully and clearly be identified and thus the profit accurately measured.

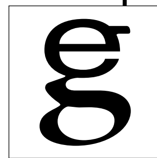
B EV Projects

The policy is to recognise income and profit prudently as the work is done – as costs are incurred on the project.

Earned Value is calculated monthly, based on the full costs of the project plus the appropriate expected profit margin. Basing the calculation on the costs to date means that the costs to date have to result in useful, saleable work done and this position is critically reviewed during the Project Review Process.

The above policy is only an outline and more detail is required.

A travel agency



Sales and deposits

Revenue is to be recognised on a prudent basis – when it has been indisputably earned.

Deposits

Deposits are of two types – refundable and non-refundable.

Accounting procedures

All deposits received, whether refundable or not, should be entered in the daily cash received sheets and full details recorded as liabilities of the business in deposit creditor accounts C564 and C565.

Accounting policy – revenue recognition

At the end of each month the deposit creditor account, non refundable deposits, C565 print out should be reviewed (by the office manager) to confirm that all entries are in respect of non-refundable deposits and that no known

disputes exist over any of the balances. On completion of this the credit balance on the account can be released to P & L account S120 as income for the month. Any likely to be disputed balances should be transferred to disputed deposits account C569 to remain as liability balances.

Commission arising on air and rail ticket sales

Accounting procedures

All ticket sales income should be credited in full to the operators account in the creditors ledger K123 to K129.

The company's calculation of commission income earned for the month should be debited to contra account K199 and credited to P & L current commission account S139.These entries are to be reversed out at the end of each month when the next month's estimates are entered and the actual agreed commission is credited to the P & L account.

On receipt of the operators' agreed commission income for the previous month, the commission amount can be released to P & L account S130.

Accounting policy

The procedures above ensure that only agreed commission is recognised as income at any month end. At the financial year end a full review of the commission calculation exercise should be carried out by the office manager.

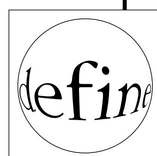
The above procedures and policies are clearly prudent and fairly detailed. It is important to understand exactly how they would operate in practice and again any accounting procedures and policy manual should have examples of the forms and accounts referred to.

Creative accounting

The term 'creative accounting' often excites interest and undoubtedly there have been many instances.

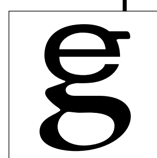
A major task of standard setters is seen to be to prevent or outlaw such practices, to ensure that accounts give a clear view of the substance of the transactions they purport to present rather than just the often minimum, purely legally required disclosure. Creative accounting can go further and be an exercise in hiding what is going on. Obviously the boundaries between creative accounting and fraud must at times be vague. The intent of the creative accountant needs to be known – is it just paranoia with secrecy or a deliberate intention to deceive?

There are many ways of being creative or misrepresenting events and transactions. Common bases for creative accounting are as follows:



Lacking prudence

This may be the concept to rely on if you want to get away with creative accounting! Prudence is very often highly subjective and a 'lighter' view on what is prudent can give better results – lower costs (accrued) or higher income recognise. A good test of whether or not there is any creativity is to check what conventional practice is among respected companies.

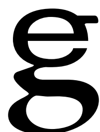


Mis matching

If clear mis matches are detected, then this may be pushing the boundaries of being creative towards being fraudulent. Examples from the past are receipts or deposits for future work or services being recorded and reported as income rather than correctly as deferred income – creditor or liability balances.

Being inconsistent

This should be rather blatant but inconsistencies could be hidden.



Netting off – window-dressing

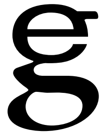
Netting off means hiding items by showing them included with other balances and only showing the net figure. An example of netting off in the balance sheet – 'window-dressing' – the balance sheet would be to show a six month money market deposit of say 4m netted against an overdraft of 7m to give a net 3m overdraft – this is not the true position!

Taking items off balance sheet

This has been an objective of many and means removing assets and more significantly related borrowings/loans from a balance sheet. The aims are to show a slimmer company – less capital employed and to hide the extent of borrowings/loans and future commitments to repay the loans.

The accounting standards on leases and UK Financial Reporting Standard (FRS) 5 – Substance of Transactions are aimed at preventing off balance sheet transactions.

Creative accounting illustration



Computer software developer

The following notes to the accounts and notes to the balance sheet demonstrate what might be done.

The small company had prudent accounting policies in respect of its expenditure in developing computer software – all costs were written off as incurred. Also the moneys it received in respect of warranties for computer hardware servicing were treated as a liability in the year they were received and were only released to the P & L account as income at the end of the year when there was no further liability to the customer to repair equipment – again a very prudent policy.

As relatively substantial sums were being expended on developing software it was considered that 'know how' was being acquired and thus the costs were more of the nature of an intangible fixed asset. The accounting policy was thus changed to permit the capitalisation of a proportion of development cost. The resulting intangible asset was then to be depreciated or amortised over a period of up to six years – really quite prudent!

In the year concerned, the company set up a new subsidiary to carry out the warranty repair work and thus took the view that instead of showing moneys received as liabilities they could now take these as income as long as they made adequate provision for any likely repair costs – still a prudent approach!

The net effect of the above was to bring credits of some 68,000 to the P & L account – all through legitimately changing the accounting policies – the changes certainly created profit.

It should be noted that all of this is disclosed in the accounts and notes and it could be said that it is up to the reader of the accounts to take note. Strictly speaking, where there are changes in accounting policies, this fact should be highlighted and the effect of the changes separately noted,

restating previous figures to show what they would have been had the new policies been in effect the previous year.

Computer software developer

Notes to the Accounts at 30 September 1995

Accounting policies

Accounting convention

The accounts are prepared under the historical cost convention.

Turnover

Turnover represents the invoiced amounts of goods sold and services provided net of value added tax.

Software development

Once it is certain that expenditure on development of software is matched by income at such a value and in such volume that development costs are likely to be recovered, expenditure (comprising mainly salaries) is capitalised and then written off over a prudent period (up to six years).

Depreciation

Depreciation is provided on all tangible fixed assets at rates calculated to write off the cost or valuation of each asset over its expected useful life as follows:

Motor vehicles	4 years
Fixtures and fittings	10-50 years
Electronic equipment	3 years

Stocks

Stocks are stated at the lower of cost or net realisable value.

Balance sheet notes

Intangible assets – software

		1994	
	£	£	
Capitalised	65,038	29,038	a
Amortisation	10,000	–	
Net Book Amount	55,038	29,038	

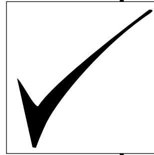
Creditors: amounts falling due within one year

		1994	
	£	£	
Overdraft	92,771	101,943	
Creditors and Accruals	66,602	91,346	
Accrued Income/ Provision for Maintenance	8,000	21,140	b
Other Taxes	30,394	30,280	
HP Liability	9,231	10,286	
Directors' Loans	46,880	14,480	
	253,878	269,475	

a The costs have been capitalised and the net effect for 1995 is a net 55,038 reduction in costs. 10,000 was taken from costs for the previous year.

b There was no note on the change in policy for the warranty income – maybe it was considered immaterial! The detail on current liabilities shows the scale of the change, instead of accruing some 20,000 of income, only 8,000 is accrued as being the costs of servicing the remaining warranties.

Checklist



- ✓ Accounting standards exist and have to be complied with.
- ✓ Know the principals of the standards which affect the reporting of your business.
- ✓ Accounting policies are a basis for you to understand your figures.
- ✓ Do you need to know your own detailed accounting policies?
- ✓ Do you need to get involved in developing your own detailed accounting policies?