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A Quick Reference Guide

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About the author

Robert J. Kirk BSc (Econ) FCA CPA qualified as a chartered accountant in 1976. He trained in Belfast with Price Waterhouse & Co., and subsequently spent 2 years in industry in a subsidiary of Shell (UK) and 4 further years in practice. In 1980 he was appointed a director of a private teaching college in Dublin where he specialized in the teaching of professional accounting subjects. He later moved into the university sector, and is currently Professor of Financial Reporting in the School of Accounting at the University of Ulster.

He has been lecturing on the CIMA Mastercourses presentations *Recent Accounting Standards* and *Accounting Standards in Depth* since 1985. He has also presented continuing professional education courses for the Institute of Chartered Accountants in Ireland over the same period.

His publications to date, in addition to numerous professional journal articles, include two books on company law in Northern Ireland, co-authorship with University College Dublin of the first Survey of Irish Published Accounts, a joint publication with Coopers & Lybrand on the legislation enacting the 7th European Directive into UK legislation and two Financial Reporting publications for the CIMA Study Packs.

Preface

The pace of development in financial reporting has accelerated sharply during the last few years, especially since the advent of the Accounting Standards Board (ASB) in 1990. The pace of progress shows no sign of abating and it has become increasingly difficult for the professionally qualified accountant to keep abreast of the changes.

UK Accounting Standards: A Quick Reference Guide examines the standards in a unique and detailed way and it has been written with a broad readership in mind. Each chapter includes a brief summary of the relevant accounting standards in force together with the proposed changes contained within the exposure drafts. A selection of illustrative examples are included which attempt to cover most of the major problem areas that practitioners are likely to encounter.

The book commences with an introduction to the standard-setting process. As well as looking at the development of the ASB it examines the conceptual framework behind the practice of financial accounting and, in particular, the Statement of Principles. It also incorporates the likely switch that companies will face in moving towards complying with international accounting standards in the near future. The next three chapters cover the key accounting problems in the balance sheet, i.e. tangible fixed assets, intangible assets and stocks and work in progress. Chapters 5 and 6 concentrate on the profit and loss account and in particular the effects of taxation and disclosure of earnings per share. Chapter 7 covers the important area of liquidity and viability by examining cash flow statements, and Chapter 8 picks up difficult pensions accounting problems as well as segmental reporting and post balance sheet events, provisions and contingencies.

The longest chapter (Chapter 9) is reserved for the accounting aspects of groups and this encapsulates accounting for acquisitions, mergers and associated undertakings. Chapter 10 concentrates on foreign currency translation, and Chapter 11 sweeps up recent developments in financial reporting.

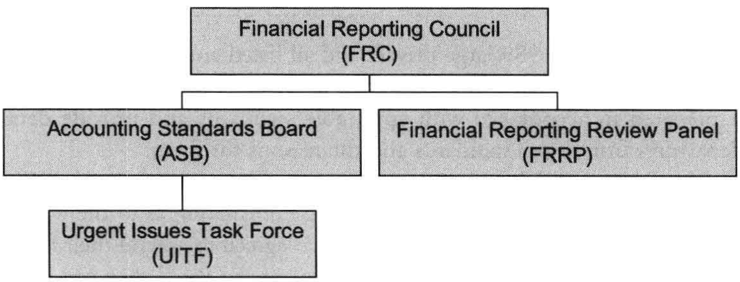
The intention of the book is that the reader will feel comfortable with basic numerical application, on an understanding of the underlying theory and on presentation of financial statements under the current regulatory framework.

Contents

Introduction

Introduction to Standard-Setting Process

The first Statement of Standard Accounting Practice (SSAP) was published in 1970 in the United Kingdom. Prior to this, there were relatively few financial reporting requirements for companies. It was the highly publicised scandals of the late 1960s, such as the GEC takeover of AEI, that brought the need for more extensive regulations and the setting up of a standard-setting body.



The Financial Reporting Council (FRC)

The FRC was set up to ensure that the standard-setting process works relatively smoothly. The role of the FRC is basically both a funding and a human resources one. They have to find approximately £3.5m to fund the operation each year and they are responsible for appointing the main personnel in the standard-setting process. In addition, they have an overall responsibility for overlooking the whole process. Membership contains both members of the profession and those who are concerned with the use, preparation and interpretation of financial statements. Once a year they publish a Review of the previous calendar year and it can be downloaded from its website www.frc.org.uk. The FRC could be described as the 'House of Lords' of the standard-setting system.

The Accounting Standards Board (ASB)

The 'House of Commons' of the new system is the main standard setter, the ASB. The ASB has ten members and is responsible for issuing standards on its own authority in the United Kingdom. To date they have published 19 Financial Reporting Standards (FRSs) as well as taking on board all the remaining nine SSAPs. However, since the emergence of the International Accounting Standards Board (IASB) in April 2001 the ASB has agreed not to issue any further standards unless these are the same as those promulgated by the IASB. It will become more like a district society rather than a major standard-setter. However, their technical resources will be used by the IASB to develop future world standards.

Standards in the past were developed by first identifying a topic from the ASB's own research or from external sources. A programme of initial consultation was then initiated which would lead to the publication of a discussion paper or consultation paper. Once that has been circulated any comments are reviewed and eventually an exposure draft is issued (known as a FRED), which outlines the intended contents of the new or revised standard. The FRED is then exposed for public comment for 3–6 months and again comments are analysed and that will result in a modified document which will eventually be published as a full Financial Reporting Standard. A list of all extant documents is provided at the end of the chapter.

The Financial Reporting Review Panel (FRRP)

Under the Companies Act 1989 large private and all listed and public interest entities are subject to review by the FRRP. They must state in writing whether or not their accounts have been prepared in accordance with applicable standards and provide details of any material departures from those standards and the reasons for them.

The Panel have investigated over 400 entities since they were set up in 1990 and have published more than 75 public press releases giving information as to the wrongdoings of the company investigated and how that company has agreed to amend their financial statements. If a company refuses to agree to the findings of the Panel they can be brought to Court and fined for non-compliance. To date (October 2004) no company has taken on the Panel and all cases have resulted in voluntary compliance by the companies concerned.

The Panel obtain their information from three sources:

1. Qualified audit reports
2. Adverse press comment
3. Whistleblowing.

Surprisingly, very few cases are discovered by qualified audit reports and most of the cases come from the latter two sources. In particular, a monthly publication, *Company Reporting*, which has a database of more than 500 companies, provides a rich vein of material for the Panel. They also have a special Whistleblowers Corner on their website www.companyreporting.com.uk in which they encourage users to complain about non-compliance with standards.

The Panel has been a reactive force over the first 12 years of their existence but they have now decided to increase their resources in the near future to introduce a more pro-active approach. In some cases the Panel has caused companies to republish their financial statements and force the Directors to pay for those republications. One of the worst cases was the case of the Wiggins Group Plc, who had to rip up 5 years' published financial statements (years ended 31 March 1996 to 2000) and reissue them. Instead of revealing 5 years increasing profit performance the revised accounts reveal 5 years' increasing losses! The company had failed to comply with a number of accounting standards as well as not complying with company legislation.

The new IASB is considering the setting up of an international Review Panel to investigate multi-national compliance with IFRSs.

The Urgent Issues Task Force (UITF)

The UITF is a sub-committee of the ASB and its role is to act as a firefighter, to ensure that any holes in existing accounting standards are covered and to ensure that any new creative accounting technique is quickly addressed. Over the first 12 years of its life it has issued 38 abstracts or consensus pronouncements. Some of these will only be temporary as they will be replaced by a more fully thought out standard in the future. However, there are still some that were issued 10 years ago that are still in exitence today. A full list of extant abstracts is provided in Chapter 10.

Other Sub-Committees

Committee on Accounting for Smaller Entities (CASE)

This sub-committee was set up to concentrate on the development and periodic revision of the *Financial Reporting Standard for Smaller Entities (FRSSE)*. That standard, which has been updated on four occasions (last in June 2002), has been designed to exempt the vast majority of limited companies from compliance with the full set of accounting standards and instead gives them the opportunity to comply with a single comprehensive standard containing the measurement and disclosure requirements that are considered most relevant to smaller entities.

In March 2004 the ASB, after advice from CASE, published a Discussion Paper *A One Stop Shop Financial Reporting Standard for Smaller Entities (FRSSE)*. This document incorporates both legal and accounting standards requirements within the one document. Currently small companies are defined in companies legislation as having a turnover not greater than £2.8m, gross assets of no more than £1.4m and up to 50 employees but these are currently being revised.

Public Sector and Not for Profit Committee

Treasury and the public sector have been committed to introducing resource accounting into the public service over the last 10 years and to introduce as much as possible of private sector accounting. In June 2003 the body recommended to the ASB the publication of a Discussion Paper *Statement of Principles for Public Benefit Entities* in which the original principles were tailored to meet the needs of the public sector. In particular, instead of investors being made the main user, funders and financial supporters are recognised and there are differences in how assets and liabilities might be defined. Overall, however, the principles are largely the same. The Committee also overviews the publication of any revised Statement of Recommended Practice (SORP) on Charities.

Financial Sector and Other Special Industries Committee

This body has the responsibility of reviewing SORPs developed for specific industries and sectors.

Authority of Accounting Standards

The ASB issued a *Foreword to Accounting Standards* in June 1993 in which it set out the authority, scope and application of accounting standards.

Authority

1. FRSs and SSAPs are 'accounting standards' for the purpose of the Companies Act 1985. The Act requires the financial statements of large companies to publicly state whether they have been prepared in accordance with applicable accounting standards and to provide particulars of any material departures from those standards and the reasons for them.
2. Members of the professional accounting bodies are expected to observe accounting standards whether acting as preparers or auditors of financial information.
3. If accountants act as Directors the onus on them is to ensure that the existence and purpose of accounting standards are fully understood by fellow directors.

The accountancy profession itself has the sanction of bringing disciplinary action against any of their members who have failed to observe accounting standards or to ensure adequate disclosure of significant departures from standards. In extreme cases members could be excluded from membership.

Scope

Applicable to all financial statements intending to provide a true and fair view of the state of a company's affairs at the balance sheet date and of its profit and loss for the financial period.

Authority

Accounting standards need not be applied to immaterial items but they should be applied to group statements which include overseas subsidiaries.

UK Standards and International Standards

The International Accounting Standards Committee (IASC) was set up in 1973 to promulgate international standards with the objective of harmonising standards on a world-wide basis. Generally these were ignored by the UK but a major decision was taken by the European Commission that all consolidated accounts of listed companies within the European Union must be prepared under these international standards for all accounting periods ending on or after 1 January 2005. In 2001 the IASC was disbanded and replaced by a new body, the International Accounting Standards Board (IASB).

The UK Government has announced, in a Department of Trade and Industry (DTI) Consultation Document published in March 2004 *Modernisation of Accounting Directives/IAS Infrastructure*, details of how non-listed companies in the UK can opt to adopt international rather than national standards as from the 1 January 2005.

The ASB has also agreed to harmonise its standards in line with international requirements. However, this process will take some years to occur and the ASB has agreed to evolve its standards slowly in that direction. In March 2004 they made a commitment to amend three standards before 1 January 2005. These standards will see the replacement of SSAP 17 *Accounting for Post Balance Sheet Events*, FRS 8 *Related Party Transactions* and FRS 14 *Earnings per Share* with IAS 10, IAS 24 and IAS 33 respectively.

There are major new topics still to be introduced, both on an international and national front in the near future. Already IFRS 2 *Share Based Payment* has been published (March 2004) and this will be incorporated as FRS 20 in early Spring 2004 into UK reporting. This will require a fair value to be measured at the date of grant of share options and that to be charged to profit and loss over the vesting period. In addition, IFRS 3 *Business Combinations* will require all business combinations to be accounted for as acquisitions as merger accounting will be banned. Goodwill will have to be treated as a permanent asset with no amortisation but with a requirement for an annual impairment review of the goodwill. It is likely that many entities will try to reclassify goodwill as other intangibles as the amortisation rules will still apply to those assets. IFRS 5 *Disposal of Non Current Assets and Presentation of Discontinued Operations* (March 2004) will eventually have to be adopted as a national standard and this will require all assets and disposal groups which are classified as 'held for sale' to be transferred to current assets and recorded at the lower of their book value and recoverable amount. It will also introduce a much 'softer' definition of a discontinued operation which could lead to a plethora of discontinued operations being disclosed in company accounts. For insurance companies IFRS 4 *Insurance Contracts* will not revolutionise accounting for insurance contracts but it will bring some consistency in choosing the most appropriate policies.

There are still major political obstacles to overcome before international standards, *in toto*, become acceptable in all countries. In France, President Chirac has written to the president of the EC about the 'nefarious economic consequences' of introducing IAS 39 *Financial Instruments: Recognition and Measurement*, particularly the need for fair value financial instruments and to record all gains and losses in the profit and loss account.

List of Extant Financial Reporting Standards and International Standards

UK Accounting Standards SSAPs and FRSs	International Accounting Standards IFRSs and IASs
SSAP 4 Accounting for Government Grants	IAS 20 Accounting for Government Grants and Disclosure of Government Assistance
SSAP 5 Accounting for Value Added Tax	–
SSAP 9 Stocks and Long Term Contracts	IAS 2 Inventories
	IAS 11 Construction and Service Contracts
SSAP 13 Accounting for Research and Development	IAS 38 Intangible Assets
SSAP 17 Accounting for Post Balance Sheet Events	IAS 10 Events After the Balance Sheet Date
SSAP 19 Investment Properties	IAS 40 Investment Properties
SSAP 20 Foreign Currency Translation	IAS 21 The Effect of Changes in Foreign Exchange Rates
	IAS 29 Financial Reporting in Hyperinflationary Economies
SSAP 21 Accounting for Leases and Hire Purchase Contracts	IAS 17 Leases
SSAP 25 Segmental Reporting	IAS 14 Segment Reporting
FRS 1 Cash Flow Statements	IAS 7 Cash Flow Statements
FRS 2 Accounting for Subsidiary Undertakings	IAS 27 Consolidated Financial Statements
FRS 3 Reporting Financial Performance	IAS 8 Net Profit or Loss for the Period, Errors and Changes in Accounting Policies
	IAS 35 Discontinuing Operations
FRS 4 Capital Instruments	IAS 39 Financial Instruments: Recognition and Measurement
FRS 5 Reporting the Substance of Transactions	–
FRS 6 Acquisitions and Mergers	IFRS 3 Business Combinations
FRS 7 Fair Values in Acquisition Accounting	IFRS 3 Business Combinations
FRS 8 Related Party Disclosures	IAS 24 Related Party Disclosures
FRS 9 Associates and Joint Ventures	IAS 28 Investments in Associates
	IAS 31 Financial Reporting of Interests in Joint Ventures

FRS 10 Goodwill and Intangible Assets	IFRS 3 Business Combinations
FRS 11 Impairments of Fixed Assets and Goodwill	IAS 36 Impairment of Assets
FRS 12 Provisions, Contingent Liabilities and Contingent Assets	IAS 37 Provisions, Contingent Liabilities and Contingent Assets
FRS 13 Derivatives and Other Financial Instruments: Disclosures	IAS 32 Financial Instruments: Disclosure and Presentation
FRS 14 Earnings Per Share	IAS 33 Earnings Per Share
FRS 15 Tangible Fixed Assets	IAS 16 Property, Plant and Equipment
	IAS 23 Borrowing Costs
FRS 16 Current Tax	IAS 12 Income Taxes
FRS 17 Retirement Benefits	IAS 19 Employee Benefits
FRS 18 Accounting Policies	IAS 1 Presentation of Financial Statements
	IAS 8 Net Profit or Loss for the Period, Errors and Changes in Accounting Policies
FRS 19 Deferred Tax	IAS 12 Income Taxes
FRS 20 Share Based Payment	IFRS 2 Share Based Payment
FRS 21	
FRS 5 Reporting the Substance of Transactions: Revenue Recognition (AN G)	IAS 18 Revenue Recognition
SORP Retirement Benefit Plans	IAS 26 Accounting and Reporting by Retirement Benefit Plans
–	IAS 30 Disclosures in the Financial Statements of Banks and Similar Financial Institutions
SBP Interim Accounts	IAS 34 Interim Financial Reporting
–	IAS 41 Agriculture
–	IFRS 1 First Time Application of Financial Reporting Standards

CHAPTER 1

The regulatory framework and the standard-setting process

1.1 Statement of Principles (December 1999)

Background

One of the main problems that has faced the standard-setting bodies in their quest to develop authoritative accounting standards was their failure to publish standards which have been consistent with each other. There has been no firm foundation on which they could be built, apart from the four fundamental concepts listed in SSAP 2. As a result the actual standards have been produced in an *ad hoc* manner with very little logical thought behind their publication. The Statement of Principles is an attempt to put this right by introducing, in a series of eight chapters, the core principles that should govern financial reporting.

Chapter 1: Objective of financial statements

This chapter argues that although there are several users of financial reporting the main user of the Annual Report is the shareholder and therefore the information should largely be directed towards his/her needs. These needs are twofold – to ensure the reporting entity has performed adequately (the stewardship function) and to ensure that the shareholder has sufficient information on which to make decisions about their future investment (i.e. the decision-making function). In order to provide information which would be helpful to users it is recommended that the entity provide information about the *financial position, performance* and *financial adaptability* of the organisation.

Chapter 2: The reporting entity

This short chapter recognises that there are two types of entity that should be publishing final accounts – the single entity and the group entity. However, the statement also requires any entity, where there is a legitimate demand for financial accounting information, to publish financial statements for their users. This would include clubs, partnerships, sole traders, charities, etc., as well as limited companies.

Chapter 3: Qualitative characteristics

This chapter identifies the key primary qualitative characteristics that should make the information in the Annual Report useful to users. There are four, two relating to the content of the Report and two in relation to its presentation.

Relevance

The information must be relevant, i.e. be up to date and current and be actually used by the reader.

Reliability

The reader must have faith in the information provided and it must be free from material error and represent faithfully what it is supposed to represent.

These two characteristics tend to come into conflict since relevance would favour the adoption of current subjective values whereas reliability would gravitate towards the adoption of historic and more objective costs. Where the two do clash the Accounting Standards Board (ASB) favours relevance.

Comparability

This is in reality the former consistency concept of SSAP 2 and insists that information must be comparable from period to period and within like items in the same period. However, it also requires sufficient disclosure for a user to appreciate the significance of transactions.

Understandability

This concept insists that the information being provided by the reporting entity be presented in such a way that it is as understandable as possible to the user. However, this does not mean that it is so simple that the information being provided becomes meaningless.

Chapter 4: The elements of financial statements

This chapter contains the key elements in a set of financial statements. It defines the balance sheet elements first and then argues that the profit and loss should pick up any residuals, for example a gain is either an increase in an asset or a decrease in a liability. The main definitions are as follows.

Balance sheet

- Asset: 'Rights or other access to future economic benefits controlled by the entity as a result of a past transaction or event.'
- Liability: 'Obligation of an entity to transfer economic benefits as a result of a past transaction or event.'
- Ownership interest: 'The residual amount found by deducting all of the entity's liabilities from all of the entity's assets.'

Profit and loss

- Gains and losses: 'Gains are increases in ownership interest, other than those relating to contributions to owners and losses are decreases in ownership interest, other than those relating to distributions to owners.'

Clearly this chapter puts the balance sheet on a pedestal with its concentration on getting the assets and liabilities right first before looking at the profit and loss. This represents a cultural swing for the UK from its current profit and loss and accruals based preference. The accruals concept is now clearly downgraded in importance in that expenditure cannot be matched against future income unless it can meet the definition of an asset in the first place. Similarly the prudence concept has been given a 'knock', as a liability can only be created if there is either a legal or constructive obligation in place. A mere intention to expend monies in the future is not sufficient on its own.

Chapter 5: Recognition in financial statements

Even if a transaction meets the definition of an asset/liability it will not be recorded on the balance sheet unless it meets the two recognition criteria or tests found in Chapter 5:

(i) Is there sufficient evidence that a change in assets or liabilities has occurred?; and
(ii) Can it be measured at cost or value with sufficient reliability?

If these cannot be passed initially then the transactions must be written off directly to profit and loss. If one of the criteria is subsequently failed then the asset/liability must be removed or derecognised from the balance sheet. It is possible that the asset/liability will need to be remeasured where there is sufficient evidence that the amount has changed, and the new amount must be measured with sufficient reliability (see FRS 5 and the use of the linked presentation approach for factored debts).

Chapter 6: Measurement in financial statements

This chapter investigates the adoption of historic costs against that of current values when evaluating assets and liabilities. The original draft chapter took the view that it would be essential long term for companies to maintain their capital in real terms and this therefore would require the use of current values in measuring assets and liabilities. However, this section was particularly heavily criticised by Lord Hanson and Ernst and Young, who saw this as a test bed for academic theories and not answering practical needs. As a result the final draft now permits reporting entities to choose either historic cost or current value, whichever would be most appropriate to a particular entity's needs to provide a true and fair view.

Chapter 7: Presentation of financial information

As promised in Chapter 1, Chapter 7 agrees that, in order to meet the needs of users, the following primary statements should be published.

(a) statement of financial performance;
(b) balance sheet; and
(c) cash flow statement.