10 Accounting principles, concepts and policies

Learning objectives

After reading this chapter the student should be able to:

1. Explain the meaning of the key terms and concepts listed at the end of this chapter;
2. Explain the nature of accounting principles, accounting concepts, measurement bases, accounting policies and estimation techniques;
3. Explain the nature of the going concern assumption, the accruals concept and the matching principle, including their implications for the preparation of financial statements;
4. Describe the objectives against which an entity should judge the appropriateness of accounting policies, i.e. relevance, reliability, comparability and understandability;
5. Describe the constraints that an entity should take into account in judging the appropriateness of accounting policies;
6. Describe the requirements of FRS18 with regard to the selection, review, changing and disclosure of accounting policies and estimation techniques.

Introduction

An appreciation of the conceptual and theoretical foundations of financial accounting is fundamental to the preparation, understanding and interpretation of final accounts and financial statements. This can be described as a set of rules, principles, postulates, conventions and methods. In order to clarify these matters, in 1971 the Accounting Standards Steering Committee (ASSC or ASC) issued *Statement of Standard Accounting Practice 2—Disclosure of Accounting Policies* (SSAP2),[1] which described the conceptual foundations of accounting as comprising accounting concepts, accounting bases and accounting policies. In 1999 this was superseded by the *Statement of Principles for Financial Reporting* published by the Accounting Standards Board (ASB).[2] SSAP2 was then replaced by the ASB *Financial Reporting Standard 18—Accounting Policies* (FRS18)[3] in 2000.

One of the main aims of this chapter is to provide a summary of the relevant parts of FRS18. The more detailed *Statement of Principles for Financial Reporting* is dealt with in Chapter 34. This chapter also draws on parts of SSAP2 which, although it has now been officially withdrawn, provides some very precise, concise and thus more easily remembered definitions.

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The nature of accounting principles

The most useful way of describing the nature of accounting principles is probably in terms of the contents of the *Statement of Principles for Financial Reporting*.[2] This comprises the following:

1. The objective of financial statements, as explained in Chapter 1 of this book.
2. The reporting entity, as explained in Chapter 2 of this book.
3. The qualitative characteristics of financial information, comprising relevance, reliability, comparability and understandability. These are explained below.
4. The elements of financial statements such as the nature of assets, liabilities, ownership interest, gains and losses. Assets are defined as 'rights or other access to future economic benefits controlled by an entity as a result of past transactions or events'. Liabilities are defined as 'obligations of an entity to transfer economic benefits as a result of past transactions or events'. Ownership interest is defined as 'the residual amount found by deducting all of the entity's liabilities from all of the entity's assets'. Gains are defined as 'increases in ownership interest not resulting from contributions from owners'. Losses are defined as 'decreases in ownership interest not resulting from distributions to owners'. LO2
5. Recognition in financial statements which refers to 'depicting an item both in words and by a monetary amount'. This includes the accruals concept which is explained below.
6. Measurement in financial statements of the elements such as in terms of their historical cost. This includes the going concern assumption. Measurement bases and the going concern assumption are explained below.
7. Presentation of financial information such as in the form of a profit and loss account and balance sheet.
8. Accounting for interests in other entities, which is beyond the scope of introductory textbooks.

Accounting principles and the *Statement of Principles for Financial Reporting* are explained in more detail in terms of a conceptual framework of accounting in Chapter 34.

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Accounting concepts

Accounting concepts were defined in SSAP2 as 'broad basic assumptions which underlie the periodic financial accounts of business enterprises'.[1] FRS18 identifies two accounting concepts that it describes as being 'part of the bedrock of accounting' and playing 'a pervasive role in financial statements'. These comprise the going concern assumption and the accruals concept.

LO3

Going concern

The going concern assumption or hypothesis is described in FRS18 as follows: 'The information provided by financial statements is usually most relevant if prepared on the hypothesis that the entity is to continue in operational existence for the foreseeable future'.[3]

The implication of this is that assets will normally be valued, and shown in the balance sheet, at their historical cost. It is assumed that the entity will continue to operate over the remaining useful life of the fixed assets. Similarly, monetary assets and liabilities, such as debtors and creditors, are shown in the balance sheet at the amounts that will be received and paid in the ordinary course of business. However, if there is reason to believe that the entity will not be able to continue in business, the assets should be valued on a cessation basis; that is, at their net realizable value.

According to FRS18, 'financial statements are usually prepared on the basis that the reporting entity is a going concern because measures based on break-up values tend not to be relevant to users seeking to assess the entity's cash-generation ability and financial adaptability.'

FRS18 requires that 'an entity should prepare its financial statements on a going concern basis, unless

a. the entity is being liquidated or has ceased trading, or
b. the directors have no realistic alternative but to liquidate the entity or to cease trading,

in which circumstances the entity may, if appropriate, prepare its financial statements on a basis other than that of a going concern.'

Furthermore, FRS18 requires that 'when preparing financial statements, directors should assess whether there are significant doubts about an entity's ability to continue as a going concern.'

LO3

Accruals concept

According to FRS18, 'an entity should prepare its financial statements, except for cash flow information, on the accrual basis of accounting.'

The accruals concept is described in FRS18 as follows: 'The accrual basis of accounting requires the non-cash effects of transactions and other events to be reflected, as far as is possible, in the financial statements for the accounting period in which they occur, and not, for example, in the period in which any cash involved is received or paid.'[3]

This description of the accruals concept broadly corresponds with the first part of the definition given in SSAP2 which states that 'revenue and costs are accrued (that is, recognised as they are earned or incurred, not as money is received or paid).'[1] The so-called 'non-cash effects of transactions and other events' being reflected in 'the accounting period in which they occur' essentially corresponds to revenue and costs being 'recognised as they are earned or incurred.' In most instances this refers to the accounting period in which the goods or services physically pass from the seller to the buyer.

LO3

In the case of sales revenue, this notion has traditionally been referred to as the revenue recognition or realization concept. It relates to the assumption that a sale is deemed to have taken place at that point in time at which the goods are delivered or services provided, and not when the proceeds of sale are received. In practice this is normally also the date of the invoice. However, where the invoice is rendered some time after the date of delivery, the sale is deemed to have taken place on the date of delivery and not the date of the invoice. This is referred to in the above SSAP2 definition of the accruals concept as being the point in time at which revenue is '*earned*'.

FRS18 contains a slightly different approach to realization which refers to the realization of profits rather than just sales revenue. It states that 'in preparing financial statements, an entity will have regard to requirements in companies legislation that only profits realised at the balance sheet date should be included in the profit and loss account… It is generally accepted that profits shall be treated as realised, for these purposes, only when realised in the form either of cash or of other assets the ultimate cash realisation of which can be assessed with reasonable certainty.'

The accruals concept also relates to the assumption that costs should be recognized as arising when they occur, and not as money is paid. That is, goods and services are deemed to have been purchased on the date they are received. This is referred to in the above SSAP2 definition of the accruals concept as being the point in time at which costs are '*incurred*'. Thus, services consumed for which no invoice has been received at the end of an accounting year (e.g. electricity, gas, telephone) are treated as a cost for that year, and the amount due is treated as a liability. These are referred to as accrued expenses. In contrast, services paid for in advance (e.g. rent, insurance, road tax, local government taxes) that have not been received at the end of an accounting year are treated as a cost of the following accounting year, and thus carried forward as an asset at the end of the current year. These are referred to as prepaid expenses or prepayments. Accrued and prepaid expenses are dealt with in more depth in a later chapter.

The accruals concept has traditionally been taken also to include the matching principle (alternatively, concept or process). This is reflected in that part of the definition of the accruals concept in SSAP2 not discussed thus far. According to SSAP2, under the accruals concept, 'revenue and costs are 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 profit and loss account of the period to which they relate.'[1]

As can be seen in the above definition, FRS18 takes a slightly different approach to the accruals concept which does not focus on when a relationship can be established or justifiably assumed. Moreover, the *Statement of Principles for Financial Reporting*[2] does not use the notion of matching as the main driver of the recognition process which focuses on the recognition of assets and liabilities and gains and losses, rather than the matching of revenues and costs. However, matching is both implicit and explicit in legislation and a number of accounting standards such as SSAP9 which is described below.

LO3

The matching principle refers to the assumption that in the measurement of profit, costs should be set against the revenue which they generate at the point in time when this arises. A classic example of the application of the matching principle is stock. Where goods are bought in one accounting year but sold in the next, their cost is carried forward as stock at the end of the year and set against the proceeds of sale in the accounting year in which it occurs. This is expounded in *SSAP9—Stocks and Long Term Contracts*,[4] as follows:

> The determination of profit for an accounting year requires the matching of costs with related revenues. (Where costs) have been incurred in the expectation of future revenue, and when this will not arise until a later year it is appropriate to carry forward this cost to be matched with the revenue when it arises; the applicable concept is the matching of cost and revenue in the year in which the revenue arises rather than in the year in which the cost is incurred.

In terms of the calculation of the gross profit in the trading account, this process of carrying forward costs takes the form of the computation of the cost of sales. The cost is carried forward by being deducted from purchases in the form of the stock at the end of the year. It is brought forward to the following year in the form of the opening stock which is matched against the proceeds of sale by virtue of its being included in the cost of sales.

A more theoretical view of the matching principle is that it refers to ascertaining profit on the basis of a cause and effect relationship. Costs cause or give rise to certain effects which take the form of revenue. Matching is thus the determination of profit by attributing specific causes to particular effects at the point in time at which the effects occur.

The accruals concept and matching principle can be illustrated vividly by a simplified example. Suppose a business only had the following transactions:

15 Jan	purchased goods costing £100 on credit
15 Feb	paid for the goods purchased on 15 January
15 Mar	sold on credit for £150 the goods purchased on 15 January
15 Apr	received payment for the goods sold on 15 March

The accruals (and matching) concept dictates that:

1. The cost of the goods was *incurred* in January.
2. The sales revenue was *earned* in March.
3. There was no profit or loss in January, February or April. The profit of £50 arose in March, the cost of the goods being carried forward as stock at the end of January and February.

LO2

The nature of measurement bases

Measurement bases are defined in FRS18 as:

> those monetary attributes of the elements of financial statements—assets, liabilities, gains, losses and changes to shareholders' funds—that are reflected in financial statements.
>
> Where a business holds an asset that was purchased, the asset will have a number of qualities that may be expressed in terms of 'values'. As well as the amount for which it was acquired, it will have a current net realisable value and, if it is capable of being replaced, it will have a current replacement cost. These are examples of monetary attributes of the asset. Other examples arise when different monetary attributes are combined in a formula. For example, in a historical cost system, stocks are stated at the lower of historical cost and net realisable value. Similarly, in a current value measurement system, the current value of an asset, using the value to the business rule, is the lower of replacement cost and recoverable amount (which is itself the higher of value in use and net realisable value).
>
> Monetary attributes fall into two broad categories—those that reflect current values and those that reflect historical values. Some monetary attributes will be suitable for use in financial statements only in conjunction with others. A monetary attribute, or combination of attributes, that may be reflected in financial statements is called a measurement basis.[3]

LO2

The nature of accounting policies

Accounting policies are defined in FRS18 as:

> those principles, bases, conventions, rules and practices applied by an entity that specify how the effects of transactions and other events are to be reflected in its financial statements through
>
> i. recognising,
> ii. selecting measurement bases for, and
> iii. presenting
>
> assets, liabilities, gains, losses and changes to shareholders' funds. Accounting policies do not include estimation techniques.
>
> Accounting policies define the process whereby transactions and other events are reflected in financial statements. For example, an accounting policy for a particular type of expenditure may specify whether an asset or a loss is to be recognised; the basis on which it is to be measured; and where in the profit and loss account or balance sheet it is to be presented.[3]

SSAP2 provided a more concise definition of accounting policies as being:

> the specific accounting bases judged by business enterprises to be the most appropriate to their circumstances and adopted by them for the purpose of preparing their financial accounts.[1]

Some simple examples of accounting policies are the choice between treating expenditure on items such as tools and equipment, and development expenditure, as expenses in the profit and loss account or as fixed assets in the balance sheet. Another example given in FRS18 is whether to include certain expenditure as a part of the cost of sales or alternatively under the heading of administrative expenses in the profit and loss account. A similar example is whether to show investments in the balance sheet as either a fixed asset or a current asset.

Accounting policies are dealt with in more detail later. The most important part of this topic at this stage comprises the objectives and constraints in selecting accounting policies discussed below.

LO2

The nature of estimation techniques

Estimation techniques are defined in FRS18 as:

> the methods adopted by an entity to arrive at estimated monetary amounts, corresponding to the measurement bases selected, for assets, liabilities, gains, losses and changes to shareholders' funds.
>
> Estimation techniques implement the measurement aspects of accounting policies. An accounting policy will specify the basis on which an item is to be measured; where there is uncertainty over the monetary amount corresponding to that basis, the amount will be arrived at by using an estimation technique.
>
> Estimation techniques include, for example:
>
> a. methods of depreciation, such as straight-line and reducing balance, applied in the context of a particular measurement basis, used to estimate the proportion of the economic benefits of a tangible fixed asset consumed in a period;
> b. different methods used to estimate the proportion of trade debts that will not be recovered, particularly where such methods consider a population as a whole rather than individual balances.[3]

These methods used to arrive at estimates, including the above examples, are dealt with in detail in subsequent chapters, particularly the next two chapters.

LO4 Objectives and constraints in selecting accounting policies

According to FRS18,

> the objectives against which an entity should judge the appropriateness of accounting policies to its particular circumstances are:
>
> a. relevance;
> b. reliability;
> c. comparability; and
> d. understandability.
>
> LO5 The constraints that an entity should take into account in judging the appropriateness of accounting policies to its particular circumstances are:
>
> a. the need to balance the different objectives set out above; and
> b. the need to balance the cost of providing information with the likely benefit of such information to users of the entity's financial statements.[3]

These are described below.

Relevance

LO5 Relevance is explained in FRS18 as follows:

> Financial information is relevant if it has the ability to influence the economic decisions of users and is provided in time to influence those decisions. Relevant information possesses either predictive or confirmatory value or both.[3]

Reliability

LO5 Reliability is explained in FRS18 as follows:

> Financial information is reliable if:
>
> a. it can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent, and therefore reflects the substance of the transactions and other events that have taken place;
> b. it is free from deliberate or systematic bias (i.e. it is neutral);
> c. it is free from material error;
> d. it is complete within the bounds of materiality; and
> e. under conditions of uncertainty, it has been prudently prepared (i.e. a degree of caution has been applied in exercising judgement and making the necessary estimates).
>
> Appropriate accounting policies will result in financial information being presented that is reliable. They will present transactions and other events in a way that reflects their substance. A transaction or other event is faithfully represented in financial statements if the way in which it is recognised, measured and presented in those statements corresponds closely to the effect of that transaction or event.

Often there is uncertainty, either about the existence of assets, liabilities, gains, losses and changes to shareholders' funds, or about the amount at which they should be measured. Prudence requires that accounting policies take account of such uncertainty in recognising and measuring those assets, liabilities, gains, losses and changes to shareholders' funds. In conditions of uncertainty, appropriate accounting policies will require more confirmatory evidence about the existence of an asset or gain than about the existence of a liability or loss, and a greater reliability of measurement for assets and gains than for liabilities and losses.[3]

Comparability

LO5 Comparability is explained in FRS18 as follows:

> Information in an entity's financial statements gains greatly in usefulness if it can be compared with similar information about the entity for some other period or point in time, and with similar information about other entities. Such comparability can usually be achieved through a combination of consistency and disclosure.[3]

LO5 SSAP2 provided a very precise definition of consistency as referring to the 'consistency of accounting treatment of like items within each accounting period and from one period to the next.'[1] For example, if the purchase of a certain type of tool or item of equipment is treated as a fixed asset (rather than an expense), then similar tools and equipment bought in the same period should be treated in the same way, i.e. as a fixed asset. Furthermore, these tools and equipment should also be treated as fixed assets in subsequent years.

Understandability

LO5 Understandability is explained in FRS18 as follows:

> Information provided by financial statements needs to be capable of being understood by users having a reasonable knowledge of business and economic activities and accounting and a willingness to study with reasonable diligence the information provided.[3]

Balancing the different objectives

According to FRS18,

> there can be tensions between the different objectives set out above. In particular, sometimes the accounting policy that is most relevant to a particular entity's circumstances is not the most reliable, and vice versa. In such circumstances, the most appropriate accounting policy will usually be that which is the most relevant of those that are reliable.
>
> There can also be tension between two aspects of reliability—neutrality and prudence. Whilst neutrality involves freedom from deliberate or systematic bias, prudence is a potentially biased concept that seeks to ensure that, under conditions of uncertainty, gains and assets are not overstated and losses and liabilities are not understated. This tension exists only where there is uncertainty, because it is only then that prudence needs to be exercised. In the selection of accounting policies, the competing demands of neutrality and prudence are reconciled by finding a balance that ensures that the deliberate and systematic understatement of assets and gains and overstatement of liabilities and losses do not occur.[3]

LO6 The disclosure of accounting policies and estimation techniques

The following are extracts from FRS18 relating to the selection, review, changing and disclosure of accounting policies and estimation techniques.[3]

> An entity should adopt accounting policies that enable its financial statements to give a true and fair view. Those accounting policies should be consistent with the requirements of accounting standards, Urgent Issues Task Force (UITF) Abstracts and companies legislation.

Where it is necessary to choose between accounting policies that satisfy the conditions above, an entity should select whichever of those accounting policies is judged by the entity to be most appropriate to its particular circumstances for the purpose of give a true and fair view.

If in exceptional circumstances compliance with the requirements of an accounting standard or UITF Abstract is inconsistent with the requirement to give a true and fair view, the requirements of the accounting standard or UITF Abstract should be departed from to the extent necessary to give a true and fair view. In such circumstances, the disclosures set out later below should be provided.

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. However, in judging whether a new policy is more appropriate than the existing policy, an entity will give due weight to the impact on comparability.

Where estimation techniques are required to enable the accounting policies adopted to be applied, an entity should select estimation techniques that enable its financial statements to give a true and fair view and are consistent with the requirements of accounting standards, UITF Abstracts and companies legislation.

Where it is necessary to choose between estimation techniques that satisfy the conditions above, an entity should select whichever of those estimation techniques is judged by the entity to be most appropriate to its particular circumstances for the purpose of giving a true and fair view.

The following information should be disclosed in the financial statements:

a. a description of each of the accounting policies that is material in the context of the entity's financial statements.
b. a description of those estimation techniques adopted that are significant.
c. details of any changes to the accounting policies that were followed in preparing financial statements for the preceding period, including:
   i. a brief explanation of why each new accounting policy is thought more appropriate;
   ii. where practicable, the effect of a prior period adjustment on the results for the preceding period, in accordance with FRS 3 'Reporting Financial Performance'; and
   iii. 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 described in (ii) or (iii) above, that fact, together with the reasons, should be stated.
d. where the effect of a change to an estimation technique is material, a description of the change and, where practicable, the effect on the results for the current period.

For any material departure from the requirements of an accounting standard, a UITF Abstract or companies legislation, particulars of the departure, the reasons for it and its effect should be disclosed. The information disclosed should include:

a. a clear and unambiguous statement that there has been a departure from the requirements of an accounting standard, a UITF Abstract or companies legislation, as the case may be, and that the departure is necessary to give a true and fair view.
b. a statement of the treatment that the accounting standard, UITF Abstract or companies legislation would normally require in the circumstances and a description of the treatment actually adopted.
c. a statement of why the treatment prescribed would not give a true and fair view.
d. a description of how the position shown in the financial statements is different as a result of the departure, normally with quantification, except where
   i. quantification is already evident in the financial statements themselves; or
   ii. the effect cannot reasonably be quantified, in which case the directors should explain the circumstances.

Where a departure continues in subsequent financial statements, the disclosures should be made in all such subsequent statements, and should include corresponding amounts for the previous year. Where a departure affects only the corresponding amounts, the disclosures should be given for those corresponding amounts.[3]

Summary

The conceptual/theoretical framework of accounting may be described as essentially being a set of accounting principles. These are said to comprise the objective of financial statements, the reporting entity, the qualitative characteristics of financial information, the elements of financial statements, recognition in financial statements, measurement in financial statements, presentation of financial information and accounting for interests in other entities.

Recognition and measurement in financial statements include two accounting concepts that have been described as 'part of the bedrock of accounting', namely the accruals concept and going concern assumption, respectively. Accounting concepts can be defined as broad basic assumptions which underlie the periodic financial accounts of business enterprises.

The going concern assumption is described as follows: the information provided by financial statements is usually most relevant if prepared on the hypothesis that the entity is to continue in operational existence for the foreseeable future. The implication of this is that assets will normally be valued, and shown in the balance sheet, at their historical cost.

The accruals concept is described as follows: the non-cash effects of transactions and other events should be reflected, as far as is possible, in the financial statements for the accounting period in which they occur, and not, for example, in the period in which any cash involved is received or paid. It has also been defined as referring to the notion that revenue and costs are accrued (that is, recognized as they are earned or incurred, not as money is received or paid). In most instances this refers to the accounting period in which the goods or services physically pass from the seller to the buyer. The accruals concept has traditionally been taken to also include the matching principle. This refers to the assumption that in the measurement of profit, costs should be set against the revenue which they generate at the point in time when this arises. A classic example of the application of the matching principle is stock.

The preparation of financial statements also involves selecting a measurement basis, accounting policies and estimation techniques. Measurement bases are defined as those monetary attributes of the elements of financial statements—assets, liabilities, gains, losses and changes to shareholders' funds—that are reflected in financial statements. Accounting policies are defined as those principles, bases, conventions, rules and practices applied by an entity that specify how the effects of transactions and other events are to be reflected in its financial statements through recognizing, selecting measurement bases for, and presenting assets, liabilities, gains, losses and changes to shareholders' funds. Estimation techniques are defined as the methods adopted by an entity to arrive at estimated monetary amounts, corresponding to the measurement bases selected, for assets, liabilities, gains, losses and changes to shareholders' funds.

The objectives against which an entity should judge the appropriateness of accounting policies to its particular circumstances are relevance, reliability, comparability and understandability. Financial information is relevant if it has the ability to influence the economic decisions of users and is provided in time to influence those decisions. Relevant information possesses either predictive or confirmatory value or both. Financial information is reliable if: it can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent, and therefore reflects the substance of the transactions and other events that have taken place; it is free from deliberate or systematic bias (i.e. it is neutral); it is free from material error; it is complete within the bounds of materiality; and under conditions of uncertainty, it has been prudently prepared (i.e. a degree of caution has been applied in exercising judgement and making the necessary estimates).

Comparability is described as follows: information in an entity's financial statements gains greatly in usefulness if it can be compared with similar information about the entity for some other period or point in time, and with similar information about other entities. Such comparability can usually be achieved through a combination of consistency and disclosure. Understandability is described as follows: information provided by financial statements needs to be capable of being understood by users having a reasonable knowledge of business and economic activities and accounting and a willingness to study with reasonable diligence the information provided.

There are also two constraints that an entity should take into account in judging the appropriateness of accounting policies to its particular circumstances which are the need to balance the different objectives set out above, and the need to balance the cost of providing information with the likely benefit of such information to users of the entity's financial statements.

There are detailed regulations relating to the selection, review, changing and disclosure of accounting policies and estimation techniques, particularly where there has been a material departure from the requirements of an accounting standard, UITF Abstract or companies legislation.

Review questions

An asterisk after the question number indicates that there is a suggested answer in the Appendix.

10.1. Describe the nature of accounting principles.

10.2. Define each of the following:
a. assets
b. liabilities
c. ownership interest
d. gains
e. losses.

10.3. a. Describe the nature of accounting concepts.
b. Explain the nature of the going concern assumption and its implications for the preparation of financial statements.

10.4. Explain the nature of the accruals concept and the matching principle. Give an example of the application of each.

10.5. Describe the nature of each of the following:
a. measurement bases
b. accounting policies
c. estimation techniques.
Give one example of each.

10.6. Explain the nature of 'the objectives against which an entity should judge the appropriateness of accounting policies' given in *FRS18—Accounting Policies*.[3]

10.7. Explain the relevance of prudence to the appropriateness of accounting policies.

10.8. According to *FRS18—Accounting Policies*,[3] there can be tensions between the objectives against which an entity should judge the appropriateness of accounting policies. Explain the nature of these 'tensions' and how they can be balanced or reconciled.

10.9. Describe the information that should be disclosed in financial statements relating to an entity's accounting policies and estimation techniques.

10.10. Describe the information that should be disclosed where an entity's financial statements contain a material departure from the requirements of an accounting standard, UITF Abstract or companies legislation.

10.11. An acquaintance of yours, H. Gee, has recently set up in business for the first time as a general dealer. The majority of his sales will be on credit to trade buyers but he will sell some goods to the public for cash. He is not sure at which point of the business cycle he can regard his cash and credit sales to have taken place.

After seeking guidance on this matter from his friends, he is thoroughly confused by the conflicting advice he has received. Samples of the advice he has been given include:

The sale takes place when:

1. You have bought goods which you know you should be able to sell easily.
2. The customer places the order.
3. You deliver the goods to the customer.
4. You invoice the goods to the customer.
5. The customer pays for the goods.
6. The customer's cheque has been cleared by the bank.

He now asks you to clarify the position for him.

Required:

a. Write notes for Gee, setting out, in as easily understood a manner as possible, the accounting conventions and principles which should generally be followed when recognizing sales revenue.
b. Examine each of the statements 1–6 above and advise Gee (stating your reasons) whether the method advocated is appropriate to the particular circumstances of his business. (ACCA)

10.12. On 20 December 19X7 your client paid £10,000 for an advertising campaign. The advertisements will be heard on local radio stations between 1 January and 31 January 19X8. Your client believes that as a result sales will increase by 60 per cent in 19X8 (over 19X7 levels) and by 40 per cent in 19X9 (over 19X7 levels). There will be no further benefits.

Required:

Write a memorandum to your client explaining your views on how this item should be treated in the accounts for the three years 19X7 to 19X9. Your answer should include explicit reference to at least *three* relevant traditional accounting conventions, and to the requirements of *two* classes of user of published financial accounts. (ACCA)

10.13. 'If a business invests in shares, and the market value of the shares increases above cost then, until and unless the business sells them, no profit is made. If the business invests in stock for resale, and the market value of the stock falls below cost then the loss is recognized even though no sale has taken place.'

'If a business undertakes an intensive advertising campaign which will probably result in increased sales (and profit) in succeeding years it will nevertheless usually write off the cost of the campaign in the year in which it is incurred.'

Rquired:
Explain the reasoning behind the application of accounting principles in situations such as these and discuss the effect on the usefulness of accounting information in relation to users' needs. (ACCA)

10.14. Classify each of the following as either a measurement basis, accounting policy or estimation technique, and explain your reasons:

a. Advertising expenditure that has been treated as a fixed asset rather than an expense;
b. The use of the straight line method of depreciation;
c. The valuation of an asset at the lower of cost or net realizable value;
d. A provision for bad debts of 5% of the amount of trade debtors at the end of the accounting period;
e. Land and buildings have been shown on the balance sheet at their current replacement cost;
f. Listed investments have been shown on the balance sheet as a current asset;
g. The historical cost of stocks has been ascertained by taking a weighted average of the prices paid during the accounting period.

10.15. One of your clients is a beef farmer. She informs you that the price of beef has fallen dramatically over the past few months and that she expects it to fall even further over the next three months. She therefore argues that the prudence principle should be applied to the valuation of her beef herd at the lower of cost or net realizable value; in this case at the latter value. She further asserts that this treatment is reasonable on the grounds that it will reduce her profit for tax purposes by the loss in value of her herd.

One of your colleagues has advised you that this may be a misinterpretation of the prudence principle and could contravene the neutrality principle. Discuss.

10.16. Nesales plc, a large food manufacturer, has purchased the brand name of a chocolate bar from one of its competitors for £5 million. It proposes to include this on its balance sheet as a fixed asset.

Cadberry plc, another large food and soft drinks manufacturer, has spent £5 million this year on promoting a new brand of chocolate bar. It proposes to include this on its balance sheet as a fixed asset.

You are required to discuss whether the proposed accounting treatment of these two items is likely to achieve 'the objectives against which an entity should judge the appropriateness of accounting policies to its particular circumstances' given in *FRS18—Accounting Policies*.[3]

10.17. Minisoft plc, a manufacturer of computer software, has spent £10 million in the current accounting year on staff recruitment, training and development. It proposes to include this on its balance sheet as a fixed asset. Discuss.

Key terms and concepts

Accounting concepts (00) ● **accounting policies** (00) ● **accounting principles** (00) ● **accruals concept** (00) ● **assets** (00) ● **comparability** (00) ● **consistency** (00) ● **estimation techniques** (00) ● **gains** (00) ● **going concern** (00) ● **liabilities** (00) ● **losses** (00) ● **matching** (00) ● **measurement bases** (00) ● **ownership interest** (00) ● **relevance** (00) ● **reliability** (00) ● **revenue recognition or realization concept** (00) ● **understandability** (00) ●

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