20 COMMON ACCOUNTING ERRORS – AND HOW TO FIX THEM

Presented by

Peter Herbert FCA

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SECTION 1: PROPERTY, PLANT & EQUIPMENT (slides 3-10)

Question 1: A client is replacing its roof. Should this be treated as a fixed asset – or should the costs be expensed?

A roof replacement is likely to be a good example of a situation where component accounting would be relevant. It would be important to remove the nbv of the roof being replaced. Depreciated replacement cost (possibly nil) could be used for this purpose (FRS 102 para 17.6) if the NBV of the replaced roof could not be otherwise determined.

Question 2: We have taken on a new client. They have a valuable property asset which is being depreciated over 50 years. The NBV will reduce to zero after 50 years. Should residual value really be ignored as it is here?

Residual value is defined in FRS 102 (glossary of terms) as 'the estimated amount that an entity would currently obtain from disposal of an asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.'

Although the expected age and condition at the end of the asset's life is taken into account, residual value is based on <u>current</u> value so, depending on the nature of the buildings, some sort of residual value would be expected. If previous depreciation has been too aggressive, we would suggest that the client simply stops depreciating the asset.

Question 3: If fixed assets are being revalued regularly, is it right to assume that no depreciation will be charged?

No, that is incorrect. Depreciation is charged in the normal way on the revalued amount up until the date of the next revaluation.

SECTION 2: OTHER ASSET ACCOUNTING ISSUES (slides 11-21)

Question 4: We have a client which is renting out part of its property which is not being used. Should this property be accounted for as PPE or as an investment property?

Paragraph 16.4 of FRS 102 (changed for periods commencing 1 January 2019 when the triennial review amendments took effect) states that 'mixed use property shall be separated between investment property and property, plant and equipment if the resulting portions could be sold separately or leased out separately under a finance lease. However, if the fair value of the investment property component cannot be measured reliably, the entire property shall be accounted for as property, plant and equipment.'

Question 5: A client has entered into a 'software as a service' (SaaS) cloud computing arrangement with a supplier where the contract conveys to the customer a right to receive access to the supplier's application software over the contract term. Because the outlay has been significant, the client wants to capitalise the costs. Is that ok?

The costs can only be capitalised if the contract gives the customer the power to obtain the future economic benefits flowing from the software itself and to restrict others' access to those benefits. Many cloud computing arrangements simply provide a service and as a result no software intangible asset is recognised.

Question 6: Companies are investing more money in their websites to create a virtual platform for business. Can these costs be capitalised?

Where organisations are moving to an online presence, they may be investing more in website development. These costs can potentially be capitalised as intangible fixed assets in company balance sheets.

For this to be the case it needs to be probable that economic benefits will flow to the entity from use of the asset and the cost or value must be reliably measurable. This is more likely to be the case where the entity is investing in e-commerce or order processing systems. It will not be the case where the substance of the expenditure is advertising and promotion.

This point is made clear in a paper produced by ICAEW's Technical Enquiries Service in August 2019:

https://www.icaew.com/technical/financial-reporting/financial-reporting-helpsheets/can-i-capitalise-website-development-costs-under-frs-102

The paper highlights the importance of considering the 'development phase' criteria in paragraph 18.8H of FRS 102 when deciding whether or not to capitalise costs:

- The project must be technically feasible;
- There must be an intention to complete the intangible asset and use/sell it;
- There must be probable future economic benefits;
- Adequate technical, financial and other resources must be available to complete the intangible asset; and
- It must be possible to measure attributable expenditure.

The paper also makes clear that a consistent policy must be adopted in respect of relevant costs.

Question 7: The market for our product has fallen off the edge of a cliff post year end. Should we mark the stock value down?

A post year end drop in stock values can be relevant to determining the net realisable value of stock – but only when the drop was a consequence of conditions existing at the year end. If the conditions giving rise to the post year end reduction in value were not in place at the year end, the reduction would be treated as a non-adjusting post balance sheet event for the purpose of the year-end accounts.

SECTION 3: LOANS & LEASES (slides 22-30)

Question 8: Our company has signed a three-year lease agreement with a car dealership. The agreement provides for a balloon repayment to be made at the end of three years to purchase the vehicle outright. The payment will reflect the market value of the vehicle at that point in time. Should the asset be capitalised?

It all depends on whether the lease agreement is a finance or operating lease. If it is a finance lease the asset will be recognised, along with the corresponding lease liability. This depends on the lessee bearing the majority of the risks and rewards of ownership.

The operating v finance lease distinction in FRS 102 is similar to the one in old UK GAAP. Under FRS 102, there is no '90% test' (as in SSAP 21) to help distinguish between finance and operating leases.

A finance lease is one which transfers substantially all the risks and rewards of ownership to the lessee. The following could individually indicate that a lease is a finance lease:

- Transfer of ownership;
- The existence of a bargain purchase option;
- Lease term for major part of the economic life of the asset;
- Present value of minimum lease payments is substantially all fair value of leased asset; or
- Specialised assets.

Other factors, per FRS 102 are:

- Losses on cancellation are borne by lessee;
- Gains or losses in residual value fall to lessee; or
- There is a secondary period at rent substantially less than market rent.

Question 9: Accounting rules stipulate different accounting rules for basic and non-basic loans. What's the difference?

Section 11 of FRS 102 defines 'basic' financial instruments. These are accounted for in a straightforward way ('amortised cost'). Any instruments which do not meet the definition of 'basic' are defined as 'other'. These are dealt with by section 12 and are accounted for at fair value through profit and loss.

Paragraph 11.9 of FRS 102 defines basic debt instruments (loans).

The conditions a debt instrument shall satisfy in accordance with paragraph 11.8 (b) are:

a) The contractual return to the holder (the lender), assessed in the currency in which the debt instrument is denominated, is:

   (i) a fixed amount;

   (ii) a positive fixed rate or a positive variable rate *(note 1)*;

   (iii) [not used]; or

   (iv) a combination of such a positive or a negative fixed rate and a positive variable rate (e.g. LIBOR plus 200 basis points or LIBOR less 50 basis points, but not 500 basis points less LIBOR).

The contract may provide for repayments of the principal or the return to the holder (but not both) to be linked to a single relevant observable index of general price inflation of the currency in which the debt instrument is denominated, provided such links are not leveraged.

The contract may provide for a determinable variation of the return to the holder during the life of the instrument, provided that:

1. the new rate satisfies condition (a) and the variation is not contingent on future events other than:

    1. a change of a contractual variable rate;
    2. to protect the holder against credit deterioration of the issuer;
    3. changes in levies applied by a central bank or arising from changes in relevant taxation or law; or

2. the new rate is a market rate of interest and satisfies condition (a).

Contractual terms that give the lender the unilateral option to change the terms of the contract are not determinable for this purpose.

b) There is no contractual provision that could, by its terms, result in the holder losing the principal amount or any interest attributable to the current period or prior periods. The fact that a debt instrument is subordinated to other debt instruments is not an example of such a contractual provision.

c) Contractual provisions that permit the issuer (the borrower) to prepay a debt instrument or permit the holder (the lender) to put it back to the issuer before maturity are not contingent on future events other than to protect:

   (i) the holder against the credit deterioration of the issuer (e.g. defaults, credit downgrades or loan covenant violations), or a change in control of the issuer; or

   (ii) the holder or issuer against changes in levies applied by a central bank or arising from changes in relevant taxation or law.

The inclusion of contractual terms that, as a result of the early termination, require the issuer to compensate the holder for the early termination does not, in itself, constitute a breach of this condition.

Question 10: A parent lends its subsidiary a large sum on an interest-free basis. This is repayable when the subsidiary sells a certain investment property. Given that there is no date for when the asset will be sold, how does the subsidiary work out whether to provide for the cost of repayment and, if it should, how much?

The first issue to consider here is whether there is a liability at all. If the subsidiary has no compulsion to ever sell the investment property, we would argue that the advance should be treated as a capital contribution (i.e. equity) in the books of the parent and the subsidiary.

Alternatively, if the parent could force the sale of the property at any time in order that the funds are returned to it by the subsidiary, then a liability would exist and it would be treated as falling due within one year in the books of the subsidiary. Legal form (as opposed to commercial substance) is a key driver when it comes to liability classification under FRS 102!

SECTION 4: PROVISIONS (slides 31-35)

Question 11: A company enters into a 10-year lease on a property. The lease contains general dilapidation provisions that the property should be made good. When should any provision be made?

The repairs create a current obligation as a result of a past event to the extent that damage to the property has been done which needs to be made good. The requirement of company B to make a provision depends on the cost of the repairs being measureable and of it being probable that the costs will actually be incurred.

Question 12: A housing association has discovered that buildings are non-compliant with building regulations. Rectification work will be undertaken to comply. Should the costs be provided for – or indeed capitalised?

A key consideration here will be whether the company can avoid spending the money. Are costs avoidable (for example by selling the property) or is there an obligation to undertake any works?

For housing associations an important consideration is whether it is possible or practical for the entity to change its future actions (changing its method of operation) to avoid meeting legal or regulatory requirements, for example, the requirements of the Tenancy Standard and the Home Standard (where costs of providing alternative accommodation may be unavoidable).

Further, consideration should be given to whether a constructive obligation may arise with residents or leaseholders by making certain representations or commitments to such third parties for particular costs that cannot be avoided.

Capitalisation will be required where (per paragraph 17b of FRS 102) costs are 'directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.' If the asset can't operate without the expenditure being incurred, it is capital expenditure.

If the costs don't meet the definition in paragraph 17.10b, the housing association will have to consider whether the costs provide incremental economic benefit (i.e. improve the asset) or replace a separately depreciated component. If either of these is the case, the costs will be capitalised.

SECTION 5: INCOME RECOGNITION CONUNDRUMS (slides 36-43)

Question 13: Jennings Limited is a property developer. It sells houses off plan. It has received some non-refundable deposits pre year end in respect of sales that will complete post year end. Should income be recorded over time or at a point in time?

Where a developer sells off plan, the sale should be recognised when risks and rewards of ownership transfer to the customer. Per example 12 in the appendix to section 23 of FRS 102, this is 'on delivery of completed real estate to the buyer'

Question 14: A major fire at an entity's premises two months before the year end resulted in it making an insurance claim. The insurance company paid out 5 months later. Should the income be accrued in the year end accounts? If it were to be accrued could the income be netted off against the cost of repairs?

The rules in paragraph 21.13 of FRS 102 apply here. An entity shall not recognise a contingent asset. However when the flow of economic benefits to the entity is virtually certain, then the related asset is not contingent and its recognition is appropriate.

If it is clear from the insurance policy that the insurance company is highly likely to pay out then the income should be accrued in the year-end financial statements.

In terms of the treatment, paragraph 21.9 of FRS 102 states that 'when some or all of the amount required to settle a provision may be reimbursed by another party (e.g. through an insurance claim), the entity shall recognise the reimbursement as a separate asset only when it is virtually certain that the entity will receive the reimbursement on settlement of the obligation. The amount recognised for the reimbursement shall not exceed the amount of the provision. The reimbursement receivable shall be presented in the statement of financial position as an asset and shall not be offset against the provision. In the statement of comprehensive income (or in the income statement, if presented) the expense relating to a provision may be presented net of the amount recognised for a reimbursement' On the basis of paragraph 21.9, the income could be netted off against the cost of the repairs in the P&L account.

Question 15: You act for a non-league football club. The club is struggling financially and has received a £100K grant from the Football Association which it intends to use over the next three years. When should the grant be recognised in the P&L account? Can deferral be justified?

FRS 102 allows the accrual or performance method when accounting for government grants. Under the accrual model of accounting in FRS 102:

- Grants relating to revenue are recognised in income on a systematic basis over the periods in which the entity recognises the related costs for which the grant is intended to compensate (paragraph 24.5D).

- A grant that becomes receivable as compensation for expenses or losses already incurred or for the purpose of giving immediate financial support to the entity with no future related costs is recognised in income in the period in which it becomes receivable (paragraph 24.5E).

Following paragraph 24.5E, it would seem appropriate to recognise the grant in full in the P&L account in the current year.

To justify deferral in the balance sheet, the club would need to provide evidence that there were specific future costs that the grant was covering. Also, arguably, FRS 102 section 24 (and thus paragraph 24.5e) does not apply to non-government grants. Although many entities have looked to FRS 102 section 24 for guidance in accounting for non-government grants during the last three years, this does not technically preclude a different approach being adopted. On that basis, deferral to the balance sheet could potentially be justified if such an approach allowed a true and fair view to prevail.

SECTION 6: OTHER PRESENTATIONAL ISSUES (slides 43-50)

Question 16: FRS 102 requires disclosure of key judgements and sources of estimation uncertainty. What's the difference?

FRS 102 requires disclosure of … judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. In short, it is typically where management have agonised over an accounting treatment.

In respect of sources of estimation uncertainty, FRS 102 requires disclosure of '… information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In short, this is where the accounting treatment is clear but management have agonised over the amount to record.

Question 17: We often hear about errors in statements of cash flows. What are the pitfalls?

Statements of cash flow are normally only required for medium-sized companies (those which breach two out of three of £10.2M turnover; £5.1M assets; and 250 employees). When statements of cash flow are included, common issues arising are:

- Poor labelling;
- Non-cash items in the statement of cashflow (especially in respect of non-cash transactions involving PPE);
- Erroneous treatment of FX movements; and
- Inconsistent classification of cash flows.

Question 18: Is it ok to recognise deferred tax assets in respect of carried forward tax losses. How bullish can we be?

This is possible. However paragraph 29.7 of FRS 102 states that 'unrelieved tax losses and other deferred tax assets shall be recognised only to the extent that it is probable that they will be recovered against the reversal of deferred tax liabilities or other future taxable profits (the very existence of unrelieved tax losses is strong evidence that there may not be other future taxable profits against which the losses will be relieved)'.

This issue was discussed in detail in a recent Financial Reporting Council thematic review which can be downloaded from https://www.frc.org.uk/getattachment/d645c79f-c4c9-4370-86b7-58dfe6780bd1/FRC-Thematic-Review-Deferred-Tax-Assets_-September-2022.pdf

SECTION 7: DIRECTION OF TRAVEL (slides 51-57)

Question 19: I've heard that there are changes afoot regarding small company filing. Is this true??

Yes. Changes to company law brought about by the Second Economic Crime Act in 2023 are expected to result in the following changes:

- A requirement for small and micro-entities to file full accounts
- A requirement for small and micro-entities to file an audit report (if audited)
- The abolition of abridged accounts for small companies

Question 20: Is it true that imminent changes to UK GAAP will bring it more in line with IFRS?

Yes. The FRC has proposed to make the following two major changes to FRS 102, probably with effect from periods commencing 1 January 2025:

- Section 23 Revenue is rewritten (and renamed) to adopt the five-step model for recognising **revenue from contracts with customers** in IFRS 15. Adoption of the latter has, for some accounts preparers, proved to be enormously challenging whilst for those with simpler contractual arrangements, the standard has been less onerous. The model has received appropriate simplifications in its adaptation within FRS 102.

- The IFRS 16 **'on-balance sheet' model for lease accounting** has been adopted. Notably, this puts the FRED at odds with the IFRS for SMEs ED, which omitted this treatment and maintains the 'operating vs finance lease' model. Again, this has been simplified for a better fit within FRS 102.