Financial reqirement system

“ FRS 5 addresses the problem of what is commonly referred to as 'off Balance sheet financing'. One of the main aims of such arrangements is tofinancea company's assets and operations in such a way that the finance is not shown as a liability in the company's balance sheet.” A further effect is that the assets being financed are excluded from the accounts, with the result that both the resources of the entity and its financing are understated.

Example: One long contract can be broken down into two or more transactions that can give rise to points at which income (irrespective of billing arrangements) should be recognized. It is important that each of these stages can be adequately valued. The amount of income to be recognized should be in line with performance of the contract (and does not have to fall in line with bills rendered or payments received).

Depending on the nature of the contract, it does mean that it is not essential that all contractual obligations need to be fulfilled to enable some income to be recognized. “ FRS 5 requires that the substance of an entity's transactions is reported in its financial statements. This requires that the commercial effect of a transaction and any resulting assets, liabilities, gains and losses are Shown and that the accounts do not merely report the legal form of a transaction.” [2]

For example, a company may sell (i. e. transfer legal title to) an asset and Enter into a concurrent agreement to repurchase the asset at the sales Price plus interest. The asset may remain on the premises of the 'seller' and continue to be used in its business. In such a case, the company [3] Continues to enjoy the economic benefit of the asset and to be exposed to the principal risks inherent in those benefits. “ FRS 5 requires that the asset

Continues to be reported as an asset of the seller, notwithstanding the transfer of legal title, and that a liability is recognized for the 'seller's' obligation to repay the sales price plus interest.” [3]

To aid its application, FRS 5 contains seven application notes that show how its requirements apply to transactions with certain features. These Are:

- Consignment stock
- Sale and repurchase agreements
- Factoring of debts
- Securities assets
- Loan transfers

“ Private Finance Initiative and similar contracts (September 1998) Revenue recognition (November 2003, however, FRS 5 has general application and is not limited to the transactions covered in the application notes.”[4] FRS 5 is effective for accounting periods ending on or after 22 September 1994. (Application Note F is effective from 10 September 1998. Application Note G is effective from 23 December 2003.)

In April 2005 the ASB issued an exposure draft of amendments to FRS 26 'Financial Instruments: Measurement' proposing implementation of the Recognition and derecognition parts of IAS 39 'Financial

Instruments: Recognition and Measurement'. If implemented, these proposals would Amend FRS 5 to exclude from its scope transactions in financial assets that would then fall within the scope of FRS 26.

“ The Accounting Standards Board’s new FRS 5 Application Note G Revenue Recognition” has been causing some consternation not least Amongst professional practices, as a result of recent press articles and Comment. The main concern is that accountancy practices and other Professional firms will face additional tax liabilities as a result of having to include partners’ time in WIP and value all their WIP at selling price.”[5]

“ The new FRS 5 Application Note applies for accounting periods ending on or after 23 December 2003. The purpose of this note is to provide information to members on the current state of the debate on this subject. The above concerns possibly arise from some overly simplistic Interpretations of the requirements of the Application Note.” [6] To date, Practising firms have valued ongoing work in progress at the lower of cost and net realisable value, in accordance with SSAP 9, until that WIP is invoiced. Our initial interpretation of the new requirements is as follows.

Work in Progress:

“ FRS 5 paragraph 13 states that the FRS (and therefore its Application Notes), does not apply where there is a more Specific standard dealing with the subject.”[7] “…therefore, for the recognition And valuation of WIP, SSAP 9 should be followed, with WIP, other than Long term WIP, valued at the lower of cost and net realisable value. “

Revenue: Revenue should now be recognised as required by “ Application Note G. Paragraph G4 of the Application Note states that a Seller recognises revenue when, and to the extent that, it obtains the right to consideration in exchange for itsperformance. Paragraph G6 clarifies. That the right to consideration may occur when some, but not all of the contractual obligations have been fulfilled."[8] Revenue should be measured at the fair value of the right to consideration. In each engagement, the question needs to be asked: at what stage does the firm obtain a right to consideration for the work done?

" It is likely that Different types of business may give rise to different patterns as to when the right to consideration arises, and the terms of business (as set out in Engagement letters) with clients will need to be checked carefully.[9] For example, in an audit engagement, it may be the case that a right to Receive some or all of the audit fee would not arise until the engagement had been completed and an audit report issued.

Whereas, in a consulting Assignment with discrete stages, a right to consideration might arise at each stage. Where a right to consideration is established, the amount Due would be recognised as revenue and in debtors, with the Corresponding costs removed from WIP. " If one is to place one's faith in self-regulation, the structure and process for setting financial reporting standards constitute the paradigm." [10]

Many practices request interim payments from clients as work Progresses. This does not necessarily imply that a right to consideration has been obtained, and amounts received in advance of obtaining that Right would need to be shown within creditors as payments received in advance. The issue of whether partner's time should be Included in WIP was addressed in the SORP on Limited Liability Partnerships (LLPs). This required that " cost" included the Cost of employee and partner time and relevant overheads, but not the Partners' profit share.

This would be persuasive in justifying the exclusion of partners' profit from WIP in other partnerships. The classification, presentation and disclosure requirements in FRS 5 apply to all non- current assets that are held for resale. However, as " held for resale" is a closely defined term, in practice only those financial assets FRS will affect which it may take a period of time to find a buyer 5 do requirements at any given balance sheet date, unless they are part of A group of assets and abilities it be disposed of together in a single Transaction.

FRS 5 also contains classification, presentation and disclosure Requirements for discontinued operations that supersedes FRS 135. These relate to the presentation and disclosure in the income statement and Cash flow statement and the timing of when an operation is classified as Discontinued.

1. b) The ICAS report Principles not Rules: A Question of Judgment cited.

FRS 5 as an example of successful judgement-based accounting

" In Britain the qualification function is very pronounced among the various professional accountancy associations."[11] Accounting standards should be firmly governed by high-level principles. FRS 5 Reporting the substance of transactions has shown that judgment-based accounting can operate successfully to report economic Reality in a situation where previously there had been over-reliance on Rules governing legal form. Those applying the rule may feel that they have a precise answer but there is no guarantee that precision means fair presentation. Comfort is drawn from mechanistic application of the detail rather than standing back to make a professional judgment on the overall picture.

Authority and enforcement are qualities of regulators, not of the words in the rules. A regulator can be equally, or more, challenging of judgment in requiring justification. Regulators must have the capacity to understand and question the judgment on the basis of stated principles, rather than seeking refuge in rules designed to ease operation of the regulatory Process.

“ Faced with widely publicized financial scandals and criticisms of financial reporting similar to those heard in the United States, the research committee of the Institute of Chartered Accountants of Scotland (rcICAS) set out in 1987 to find an alternative to historical cost accounting.”[12]

Financial statementshould be capable of comparison when the economic

Reality of similar transactions and events are understood in a similar way by the users if those financial statements. The disclosure by the preparer of judgments made is key to that understanding.

“ An analogous but not identical dichotomy as 'rules vs. processes' in prudential regulation can be found in the conduct of business field. This can be referred to as 'rules vs. principles'. Both pairs of concepts share the basic feature that they contrast formal and detailed requirements (i. e. 'rules') with regulations, which allow, and indeed require, substantial involvement of individual firms and ample flexibility as regards the compliance with the set requirements (i. e. 'processes' or 'principles').”[13]

Rules based standards cause complexity and delay in keeping abreast of Change. The complexity of rule-based standard is only a consequence of the complexity of the underlying business.

Rule based standard deter creative accounting. Rule based standards

Foster creative accounting by diverting judgment from economic reality to the detail of application. Creative accounting under rule based regimes to make it unnecessary to quote specific cases. Rule based standards set out greater detail, which is especially important where translation is needed.

There is a need for considerable technical guidance in countries where Principles based standards are a new idea and there has been a custom of relying on statutory regulation and strong governmental guidance.

A principles-based approach to standard setting is not only desirable but Essential, to serve the needs of business and the public interest and that the global convergence of accounting standards cannot be achieved by a Detailed rules-driven approach.

The working group believes that Principles-based standard setting will require: a change in the global Profession, with preparers and auditors assuming moreresponsibilityfor their judgments; the documentation of key judgments in the financial Statements; and regulators are accepting a range of judgment-based Outcomes. The working group believes that rules-based accounting adds unnecessary complexity, encourages financial engineering and does not necessarily lead to a ‘ true and fair view’ or ‘ fair presentation’.

“ On March 5th 2004 the Financial Reporting Committee (FRC) issued a working draft of guidance on FRS 5 and the valuation of work in progress, which has the title of 'Application of FRS 5 Application Note G : ‘ Revenue Recognition’ to contracts for professional services' in the draft. The consultation period ended on Monday 15 March, in time for a meeting of the FRC later that day. The article Practical application guidance of FRS 5 Application note G and UITF 40 to law firms, which was originally published in the July 2005 edition of Solicitors Group News, has been made available in full text on the Technical Policy website. “[14]

The whole emphasis of this subject is to ensure that income is recognized at an appropriate time. Most professionals know that the timing of billing can easily be manipulated so that accounts can give a distorted view. This guidance is attempting to give some clarity as to how income should be recognized. The guidance does contrast between contracts that last for more than twelve months and those under twelve months, but in practice their treatment is similar where the contract ps the year-end.

Faced with widely publicized financial scandals and criticisms of financial reporting similar to those heard in the United States, (The year 2002 witnessed major upheaval in the United States with the Enron and the WorldCom scandals. Throughout the United States there was major concern in corporate and financial sectors during the early years of the 1990's as to the value of business information and the confidence people had in this information), the research committee of the rcICAS set out in 1987 to find an alternative to historical cost accounting. The findings should be of considerable interest to U. S. practitioners facing identical issues.

The ICAS research committee set out a blueprint for future reporting practices of linked companies (quoted enterprises) focusing on original empirical research work into current practices of users of business information including institutional investors, broker analysts and bank leaders. Their findings identified that: 'the analysis of the decision making process identified for attention the cycle ofcommunication, the importance of maintaining confidence, the ability of expert users to explore and sift data, their selective use of key measures and the importance they attach to information about change'.

The ICAS is one of *the* seven delegated professional associations. This prestigious position resonates with most Government policy-makers and permitted an awkward resolution of the dilemma it faced through its adherence to contradictory principles of monopoly and competition. The resulting *polymorphous* model of professionalization represented a complex solution to these conflicting interests and ideological crosscurrents.

The Government's polymorphous model sought to preserve diversity, and defend itself against accusations of creating a " closed shop," within a common framework. The Insolvency Act created the new profession of insolvency practice. All the normal functions of professional associations--admissions, examinations, code of ethics, discipline, continuingeducation.

ICAS has an established reputation for producing accountants of the highest calibre who are able to find employment throughout the world. These six associations also endow their individual members with high levels of professional status which is normally reflected in both their salaries andcareerprospects.

The secondary register is constituted by organisations which have impressive names including the Association of International Accountants; the Society of Company and Commercial Accountants; the Association of Authorised Public Accountants and the Association of Cost and Executive Accountants. All offer a qualification of some description and in the past have proved particularly popular with foreign students. Although these qualifications have never been recognised by the international accounting community the existence and persistence of such organisations illustrates the importance of a qualification within the profession.

These second register bodies should not be confused with several other bodies including the Association of Accounting Technicians (AAT), the Institute of Internal Auditors (IIA) and the Institute of Company Secretaries and Administrators (ICS A), each of which offers a qualification of recognised value.

With ICAS, there is a historically grounded frame of disciplinarity within which there are a limited but variable number of ways in which attainment may be understood and pursued in the accountancy field. In particular, its observed that a significant move towards wishing to be more transdisciplinary, but with a desire to retain all the benefits of being specialist at the same time.

This is, therefore, a particularly interesting moment in which to be proposing new approaches to attainment, i. e. FRA 5. There is, in our view, a considerable openness to radical forms of change. At the same time, to achieve such change is likely to need particular attention being paid to the issues of context, power and perspective, given the new way that disciplinarity is potentially to be enacted.

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