IAS 8 Accounting policies, changes in accounting estimates and errors (Final Revision checklist)

IAS 8 is a generic standard that applies to all entities and to all transactions because it is about accounting policies, changes in accounting estimates and errors which affect all entities and all stages of the financial accounting and reporting process.

OBJECTIVE OF IAS 8

1. To understand the objective of IAS 8 it is essential to review the IASB *Framework* elements:

- Objectives of financial reporting
- Assumptions (principles) of financial accounting and reporting
- Elements of financial reporting
- Qualitative characteristics of financial reports
- Capital maintenance

2. IAS 8 addresses the **assumptions** of financial reporting in ways that enhance the **qualitative characteristics** of financial reports as set out in the *Framework*. In particular, it addresses the requirements of **comparability** by requiring restatements of previous years' comparative figures after prior year errors are recognised in the financial statements of the current reporting period. In addition, it enhances the reliability and relevance of the financial statements by allowing changes in accounting estimates stemming from new information and new developments relating to items previously recognised in the financial statements to be adjusted immediately in the current reporting periods in which the information comes to light.

3. IAS requires the entity to focus on the requirements of the Framework for consistent and useful information by requiring policies to be determined that i) record and measure the effects of transactions, ii) allow useful information and interpretations, iii) allow comparisons to be made between the entity's periodic information about performance and between the entity's performance and that of other similar entities in then same industry.

ACCOUNTING ASSUMPTIONS, ACCOUNTING BASES AND POLICIES

4. The following table gives a brief outline of the determinants of accounting assumptions, bases and policies. Refer to **Accounting policies** in P2 terms and techniques for more in-depth discussion.

Accounting assumption *These are the basic principles that underpin the recognition and reporting of transactions.*	**Accounting base** (*answers the question in relation to measurement on what are the numbers based*? In relation to recognition on what basis are the amounts recognised? In other words what is the specific assumption made to determine the amount recognised in applying the	**Accounting policy** (this is a statement of how the company chooses to apply a specific accounting base to record and measure the effects of relevant transactions for the purpose of producing useful and relevant information.)

	relevant ***accounting assumption***?)	
Going concern: an entity will continue in operational existence for the foreseeable future unless management intends to **liquidate** the entity or to **cease trading**.	The **business model** will determine the accounting base e.g. is the asset's *carrying value* to be recovered through continuing use or sale? **Continuing use** will dictate historical or current replacement cost bases for the measurement of **carrying values as the accounting objective** is to allocate the costs to future periods based on use. If the carrying value is to be recovered through sale e.g. inventory, disposal group, subsidiary and derivatives classified as *held-for- sale* this would imply the use of fair values (and net realisable values NRV) as the accounting objective would be to determine the **recoverable amount** and make sure it is not less than the carrying values.	A statement that states and explains the basis of measuring carrying values to inform users and maintain consistency.
Accrual or matching: costs are matched against revenue from goods and services delivered to determine the profit for the period.	Revenue recognised in the period is based on the goods and services sold in the period. Cost is recognised based on what is required to produce goods and services recognised as revenue. *Examples*: Cost of goods sold Depreciation	Revenue is recognised based on goods and services sold to customers in the reporting period (completed transactions).
Consistency affects: Recognition Measurement Presentation Disclosure	Its effects can be seen in: - **Units of account** maintained over several periods and business units e.g. operating assets classified as property, land and equipment - **Valuation units** e.g. share capital accounts	Use the same accounting policies to recognise, measure, present and disclose identical items only varying from the standard to justify producing relevant and reliable information that would otherwise not be available.

Consistency's foundations are - Faithful representation - Going concern - Comparability - Relevance: predictability and confirmatory value: is the outcome in accordance with what was expected?	by category (not units of shares) such as ordinary shares, preference shares, valuation premise as in IFRS 13 *Fair values* - **Cash generating units** CGUs as in IAS 36 Impairment of assets.	Group, describe and present like items e.g. Finished goods of inventory PPE Investment property Disclose accounting policies consistently - About the relevant activities that significantly affect earnings - Where a choice is made among options - Based on what users expect - Where mandated by IFRS - Where there is more than one measurement base - Where the nature of the item such as corporate social responsibility warrants it.
Materiality: The item's (or group of items' collective) ability to influence user perceptions, evaluations and decisions. Driven by the <u>nature</u> and <u>relative size</u> of items and their context.	The accounting base of materiality is determined by its relevance in context; this must be assessed and judgement should be applied as to whether decision-useful information can be produced above the materiality level set.	The accounting policy regarding materiality should operate at three levels: - Recognition and measurement - Disclosure of amounts in notes to enhance the quality of financial information - Policy disclosures: only adopting and disclosing those policies that have material effects on the financial statements.
Aggregation: Aggregation is related to materiality and consistency in that <u>items that are not material</u> are combined into the same unit of account and as one line in the primary statements (SOCI, SOFP, SOCE and SOCF).	Aggregation operates at the following levels - Unit of Account - Presentation on financial statements level - Segment level - Business level e.g. SBU or divisional level - CGU level	The accounting policy reflects the level of aggregation and is disclosed as in IFRS 8.
Substance over form Transactions, conditions and other events are reflected in the accounting records and presented in the financial statements **on the basis of their economic substance** – not on the legal form or the underlying contracts or agreements. This principle underpins the treatment of significant transactions such as	The accounting policy is based on the economic substance of the transaction. Key factors that determine economic substance - transfer of risks and rewards of ownership and control; - changes in cash flow patterns - continuing involvement - identifiability as in intangible assets	The policy determines recognition and measurement based on the accounting base and ensures consistency of determination between periods and entities undertaking similar activities.

- Leases: the lessee recognises the asset under a finance lease even though the lessor retains ownership. - In a sale and lease-back transaction the lessor is deemed to have raised a loan rather than sold the asset.	- commercial viability as in development expenditure.	

5.

SELECTING A SUITABLE ACCOUNTING POLICY

6. Accounting policies determine the recognition, measurement and presentation of transactions and their effects on the financial performance and position of the entity. They are therefore disclosed in financial reports to aid understanding and interpretation.

What is a *suitable* accounting policy?

7. An accounting policy is ***suitable*** if it reflects the nature of the transaction and its effects. In other words the choice of accounting policy must be governed by the business model - this is an *essential* condition for the information produced as a result of the application of the policy to be relevant and reliable. The business model is the way that management has chosen to use the entity's competences in deploying resources through activities and processes to meet customer expectations.

8. Below is an extract from Barclays published accounts 2012

Barclays Bank Plc
Classification and measurement Financial assets and liabilities are initially recognised at fair value and may be held at fair value or amortised cost depending on the Group's intention toward the assets and the nature of the assets and liabilities, mainly determined by their contractual terms.
Accounting for interest income and expense The Group applies IAS 39 Financial Instruments: Recognition and Measurement. Interest income on loans and advances at amortised cost, available for sale debt investments, and interest expense on financial liabilities held at amortised cost, are calculated using the effective interest method which allocates interest, and direct and incremental fees and costs, over the expected lives of the assets and liabilities. The effective interest method requires the Group to estimate future cash flows, in some cases based on its experience of customers' behaviour, considering all contractual terms of the financial instrument, as well as the expected lives of the assets and liabilities. Due to the large number of products and types (both assets and liabilities), there are no individual estimates that are material to the results or financial position.
Assets and liabilities held at fair value

This section presents information regarding assets and liabilities the Group holds and recognises at fair value. Fair value refers to the price that would be received to sell an asset or the price that would be paid to transfer a liability in an arms length transaction with a willing counterparty which may be an observable market price or, where there is no quoted price for the instrument, may be estimated based on available market data. Detail regarding the Group's approach to managing market risk can be found on pages 121 to 129.

15 Trading portfolio

Accounting for trading portfolio assets and liabilities (Held for trading, classified as at FVTPL)

In accordance with IAS 39, all assets and liabilities held for trading purposes are held at fair value with gains and losses arising from changes in fair value taken to the income statement in net trading income (Note 5)

4 Net fee and commission income

Accounting for net fee and commission income

The Group applies IAS 18 Revenue. Fees and commissions charged for services provided or received by the Group are recognised as the services are provided, for example on completion of the underlying transaction. (Examples of fees are arrangement fees: i) arrangement fees, ii) facilitation fees, iii) commission. These are encountered under financial instruments, IAS 32.)

5 Net trading income

Accounting for net trading income

In accordance with IAS 39, trading positions are held at fair value and the resulting gains and losses are included in the income statement, together with interest and dividends arising from long and short positions and funding costs relating to trading activities.

Income arises from the sale and purchase of trading positions, margins which are achieved through market-making and customer business, and from changes in fair value caused by movements in interest and exchange rates, equity prices and other market variables.

Own credit gains/(losses) arise from the fair valuation of financial liabilities designated at fair value through profit or loss. See Note 19 Financial liabilities designated at fair value.

6 Net investment income

Accounting for net investment income

Dividends are recognised when the right to receive the dividend has been established. Other accounting policies relating to net investment income are set out in Note 18, Available for sale financial assets, and Note 16, Financial assets designated at fair value.

16 Financial assets designated at fair value

Accounting for financial assets designated at fair value (Fair value option**)**

In accordance with IAS 39, financial assets may be designated at fair value, with gains and losses taken to the income statement in net trading income (Note 5) and net investment income (Note 6). The Group has the ability to do this when holding the instruments at fair value reduces an accounting mismatch (caused by an offsetting liability or asset being held at fair value), is managed by the Group on the basis of its fair value, or includes terms that have substantive derivative characteristics (Note 17 Derivative financial instruments).

9. Examples of business models and suitable accounting policy indicators:

Business model	Suitable accounting Policy (Asset)	Suitable accounting policy (Profit or Loss)
Bank makes mortgage loans that are repaid piecemeal in accordance with the agreed schedule.	Amortised cost – unexpired obligation. - measured at PV of cash flows - IAS 36 impairment losses recognized before re-measurement of amortised cost	- Interest is accrued on outstanding capital - Impairment loss recognized in profit or loss - Impairment loss recovered through profit or loss
Bank buys bonds to receive interest on capital which is repaid on maturity.	Amortised cost	Interest is accrued on outstanding capital
Bank leases asset under a finance lease	Capitalise the asset	Depreciate the asset
Bank provides finance to manufacturing company to lease an asset (plant for manufacturing)	Long–term loans	Interest accrued
Manufacturing company arranges finance (with a bank) for customers to purchase cars and other assets	Recognises an asset (Cash)	Accounts for lease asset as a sale facilitated by leasing.

Business model – an analysis of how a policy is chosen to suit the business model

10. For example, if the value of a pure vanilla bond is measured at amortised cost at the reporting date the accounting policy is <u>suitable</u> because the amount determined on the basis of amortised cost represents the remaining obligations for repayment of capital and payment of interest at the end of the reporting period. Clearly, fair value would not be a suitable measure of the amount of outstanding obligation at the reporting date because the bond was originally issued purely for the purpose of raising finance as a result of which an obligation was incurred by the organisation to pay interest on the outstanding capital and repay the capital itself in accordance with the contract, usually at maturity. There was no opportunity for capital gain.

11. However, fair value would be a suitable measure for a convertible bond with an option to convert to equity. The conversion option is an *embedded call option* which creates an opportunity for capital gain should the holder wish to exercise it. This means that the interest of the holder in the bond is no longer solely in the interest and capital payment. Accordingly, IFRS 9 prohibits the use of amortised cost to measure it, instead recommends fair value. Refer to table 3 in the IFRS 9 Workbook for practice on determining accounting policies for financial instruments.

What is an *<u>acceptable</u>* accounting policy?

12. In addition to being suitable the policy must also be ***acceptable,*** meaning that it must not conflict with other policies and must not give a view that is not true and fair. This means it must be realistic and balanced. Below is an example of a policy that may be suitable but not acceptable.

Financial Guarantee Contract – an example of what is not acceptable

Background information

A financial guarantee contract is an agreement by the issuer to pay a creditor (the holder) the amount owing should the debtor default under an approved contract for the payment of the debt. The question is how should it be accounted for (by the holder)? As

i) A financial instrument? A contingent right to receive cash? IFRS 9 2010/IAS 39

ii) An insurance contract under IFRS 4? or

iii) A contingent asset under IAS 37

The above are all plausible. However, as can be seen below iii) is only evoked as a last resort. Check the published accounts for their policies on financial guarantee contracts e.g. Tesco plc.

THE REASONS WHY A GUARANTEE SHOULD NOT BE AUTOMATICALLY RECOGNISED AS A CONTINGENT ASSET UNDER IAS 37 *Provisions, contingent liabilities and assets*. If it is then the guarantee would be deemed a reimbursement for loss (due to impairment) which, under IAS 37 is not recognised unless it is virtually certain it would be received. Meanwhile an impairment loss would be justifiably recognised under IAS 39 (IFRS 9). Clearly, this lack of symmetry would not be *acceptable* as it would produce an unbalanced outcome.

13. Sources of information and guidance for *accounting policies*:

- **Accounting standards**
- **Interpretations** (issued by IFRS Interpretations Committee responsible for developing *interpretive guidance*) to restrict interpretations to what is acceptable where a standard does not specifically address an issue or where the standard leaves opportunity for divergent interpretations that could undermine comparability.
- **Implementation Guidance** (issued by the Board) accompanying IFRS; can be *integral* to the standard in which case it is mandatory or it may not be integral in which case it is not mandatory but useful and persuasive.
- **Management judgement** of the best way to represent the transactions given the business model and the need to achieve true and fair view e.g. the fair value option classification of financial instruments

14. Where a standard specifically applies to a transaction, condition or other event, the accounting policy that applies to that transaction, condition or other event is determined by applying the standard, its interpretation and implementation guidance,

Where there is no standard or interpretation (hierarchy rules)

15. Where there is no Standard or Interpretation that specifically addresses a particular transaction, other event or condition, IAS requires management to use its judgement to develop and apply an accounting policy that produces relevant and reliable information. **In exercising judgement management is required to refer to and consider the applicability of, in that order**

a) the *requirements* and *guidance* in Standards and Interpretations (IFRICs) **dealing with similar and related issues**;
b) the definitions, recognition criteria and measurement concepts of assets, liabilities, income and expenses in the *Framework*.

Management may also refer to recent pronouncements of standard setting bodies (such as the USGAAP) that use a similar conceptual Framework to set standards, accepted industry practices and recent accounting literature to the extent they don't conflict with the above sources.

Thus the *Framework* serves as a guide for preparers to resolve accounting issues in the absence of more specific guidance.

16.

APPLYING CHANGES IN ACCOUNTING POLICIES

17. A change in accounting policy can be mandatory (required by the new IFRS) or voluntary (initiated entirely by the management). Where the change is required by the new IFRS the transitional provisions of the IFRS must be complied with. Where the standard has no transitional provisions or where the change is entirely voluntary the change should be applied *retrospectively*. This means that the new policy is applied to transactions and other events and conditions as if it had always been the policy of the entity.

Practical impact

18. The practical impact of the above requirements of IAS 8 is that in the year in which the new policy is adopted *corresponding amounts* must be restated in terms of the new policy as if the new policy had been adopted in preparing the financial statements of the previous year.

19. Below is a case study illustrating the impact of the change in accounting policy on the

THE IMPACT OF A CHANGE OF ACCOUNTING POLICY

In 2009 Anil changed its accounting policy for valuing stocks. Up to 2008 stocks were valued on weighed average cost basis. This was changed to first-in first-out to reflect more accurately the inflow and outflow of stocks in the entity. The impact on inventory valuation was as follows:

	Increase of
	$
At 31 December 2007	10,000
At 31 December 2008	15,000
At 31 December 2009	20,000

The statement of comprehensive income prior to adjustment is:

	2009	2008

	$	$
Revenue	250,000	200,000
Cost of sales	100,000	80,000
Gross profit	150,000	120,000
Admin	60,000	50,000
Selling, distribution	25,000	15,000
Net profit	65,000	55,000

Required

Discuss and apply the changes in accounting policy to the financial statements of Anil in accordance with IAS 8.

Solution

Analysis

- The effect of the change in accounting policy is to reduce cost of sales in each of the affected periods. The required adjustments are therefore to reduce cost of sales and correspondingly increase profits. The effects of these changes can be seen in the revised comprehensive income statements below.
- Because of the requirement to *restate the previous period's figures in terms of the new policy* there are effectively three periods involved (year ending 31 December 2009, 2008, 2007). This is because the comparative period (2008) to the current period (2009) includes retained earnings of the preceding year 2007 (brought forward).
- The **adjustments** to the current (2009) and comparative (2008) reporting periods are the **net decrease** in the cost of sales of $5,000 each.
- The *earliest period presented* is year ended 31 December 2008. Therefore the prior period to the earliest period presented is year ended 31 December 2007.The adjustments to the retained earnings of the prior period is the whole of the effect of the change of policy on 2007 stocks ($10,000). This is because IAS 8 does not require any preceding period to be adjusted.

EFFECT OF CHANGE IN STOCK VALUATION POLICY

	Increase of	Opening stock	Net impact on Cost of sales
	$		$
At 31 December 2007	10,000	2008 opening stock	(10,000)
At 31 December 2008	15,000	2009 opening stock	(5,000)
At 31 December 2009	20,000	2010 opening stock	(5,000)

EFFECT OF CHANGE IN STOCK VALUATION POLICY

	2009	2008
	$	$
Revenue	250,000	200,000
Cost of sales	95,000	75,000
Gross profit	155,000	125,000
Admin	60,000	50,000
Selling, distribution	25,000	15,000
Net profit	70,000	60,000

STATEMENT OF CHANGES IN EQUITY (Retained earnings only)

	Retained earnings	Retained earnings	
	$	$	
At 1 January 2008, as previously stated	300,000	300,000	Beginning of the earliest period presented (Year ending 31 December 2008)
Effect of change in accounting policy	10,000		Adjustment to the retained earnings of the prior period (Year ended 31 December 2007)
At 1 January 2008, as restated	310,000	300,000	
Net profit for the year as restated	60,000	55,000	
At 31 December 2008	370,000	355,000	
Net profit for the year	70,000	65,000	
At 31 December 2009	440,000	420,000	

20.

CHANGES IN ACCOUNTING ESTIMATES

21. A change in accounting estimate is an adjustment of the carrying amount of an asset or a liability or rate of consumption of an asset arising from current assessments of the condition of an asset, or the expected future benefits from assets, or obligations relating to liabilities.

22. A change in an accounting estimate can occur because of new information or new development in relation to items estimated for inclusion in the financial statements such as

Subject of estimate	New information/Development
Business combinations	
Employee share option expenses	New information about performance or about the number of employees likely to satisfy vesting conditions
Bad debt provision	
Depreciation	
Restructuring provision	
Warranty provisions	
Pension fund service costs	Past service costs relating to employee benefits that are **vested**. If an employee's pensionable service years are five years, pension benefits are said to have vested on the completion of the fifth year of service. The five year period is known as the vesting period. Before the completion of the vesting period the benefits are said to be **unvested**. Enhancements of pension benefits during the vesting period may relate to past periods of service. The related costs are known as past service costs. These costs are recognised in the period of amendment for both vested and unvested benefits.

23. Estimates, based on informed assessment of commercial circumstances, events and conditions, are a significant part of the financial accounting and reporting process. Changes to estimates are not therefore *correction of errors* as defined by IAS 8. There are inherent uncertainties in the process of estimating, being an attempt to predict the future which is dependent on factors over which the entity has little control.

24. The financial accounting and reporting process must therefore allow, as part of that process, the periodic adjustments to the current year's results in respect of the estimates of previous years. IAS 8 allows these adjustments to be effected in the current and future periods if required. However, changes in accounting estimates cannot be made retrospectively.

25. Circumstances may make it hard to distinguish between changes in accounting estimates and changes in measurement bases (changes in accounting policy). In those circumstances the change should be treated as a change in accounting estimates.

26. Examples

27.

CORRECTION OF PRIOR PERIOD ERRORS

28. According to IAS 1 a fair presentation is achieved by compliance with applicable IFRS. To the extent that financial statements contain material errors, omissions or manipulation to achieve a certain presentational effect they are not in compliance with IFRS.

29. IAS 8 defines a **prior period error** as "omissions from and misstatements in financial statements for one or more periods, arising from a failure to use, or misuse of, reliable information that was available at the time and could reasonably be expected to have been obtained and taken into account in the preparation and presentation of financial statements." http://www.youtube.com/watch?v=NxFks7Lud3M

30. Errors are material if they could on their own or in combination with other errors influence the decisions of users.

31. Discovery of material errors relating to prior periods must be corrected by restating comparative figures in the financial statements for the year in which the error is discovered, unless it is impracticable to do so.

32.
33.

34. Clarity and quality of discussion Revise the glossary from … and test your knowledge rigorously using i) objective tests; ii) fill in the blanks; iii) match the concept	
Key terms	
Key words	

Key phrases: it is worth memorizing these as **prepared phrases** could potentially save you time in the exams and make your answers read more professional.	
35. News digest & Developments	http://ec.europa.eu/eu_law/introduction/what_regulation_en.htm APPLICATION OF EU LAW TO IFRS 1. EFRAG (European Financial Reporting Advisory Group) assesses new standard and issues technical recommendation to EC and ARC (Accounting Regulatory Committee) 2. EC votes on standard (may reject all or parts). Once approved by voting Regulation is published in EU Journal and standard passes into law within three days of publication. However, effective date of application of the standard is governed by the IFRS effective date which may be reflected in the Regulation itself. 3.