Section 10 / IAS 8

- Presentation of Financial Statements

- Accounting policies
- Accounting estimates
- Accounting Errors

Overview

- Objective and scope
- Selection and application of accounting policies
- Changes in accounting policies
- Changes in accounting estimates
- Corrections of errors

Objective and Scope

- Key is comparability

- Objectives:
  - How to choose accounting policies
  - Reporting changes in accounting policies
  - Reporting changes in estimates
  - Reporting the correction of errors

Selection and Application of Accounting Policies

For a specific transaction or event -

First, look to the IFRS that deals specifically with that situation:

- International Financial Reporting Standards,
- International Accounting Standards, and
- Interpretations developed by IFRIC or predecessor SIC

Appendices and implementation guidance attached to these are an integral part of each <u>only if stated</u> on the specific standard.

Selection and Application of Accounting Policies

- IFRS standards and interpretations - top of the *GAAP hierarchy*
- When applied – information is assumed to be relevant and reliable
- What if no specific IFRS that applies?

Selection and Application of Accounting Policies

- If no specific IFRS that applies:
  - Use judgment
  - Develop a policy that results in relevant and reliable information
  - Hierarchy of sources to use
    - Other IFRS with similar situations and issues
    - Conceptual framework basics
    - If not in conflict with above, use other sources:
    - Pronouncements of other standard setters with similar frameworks, accounting literature, accepted industry practice, etc.

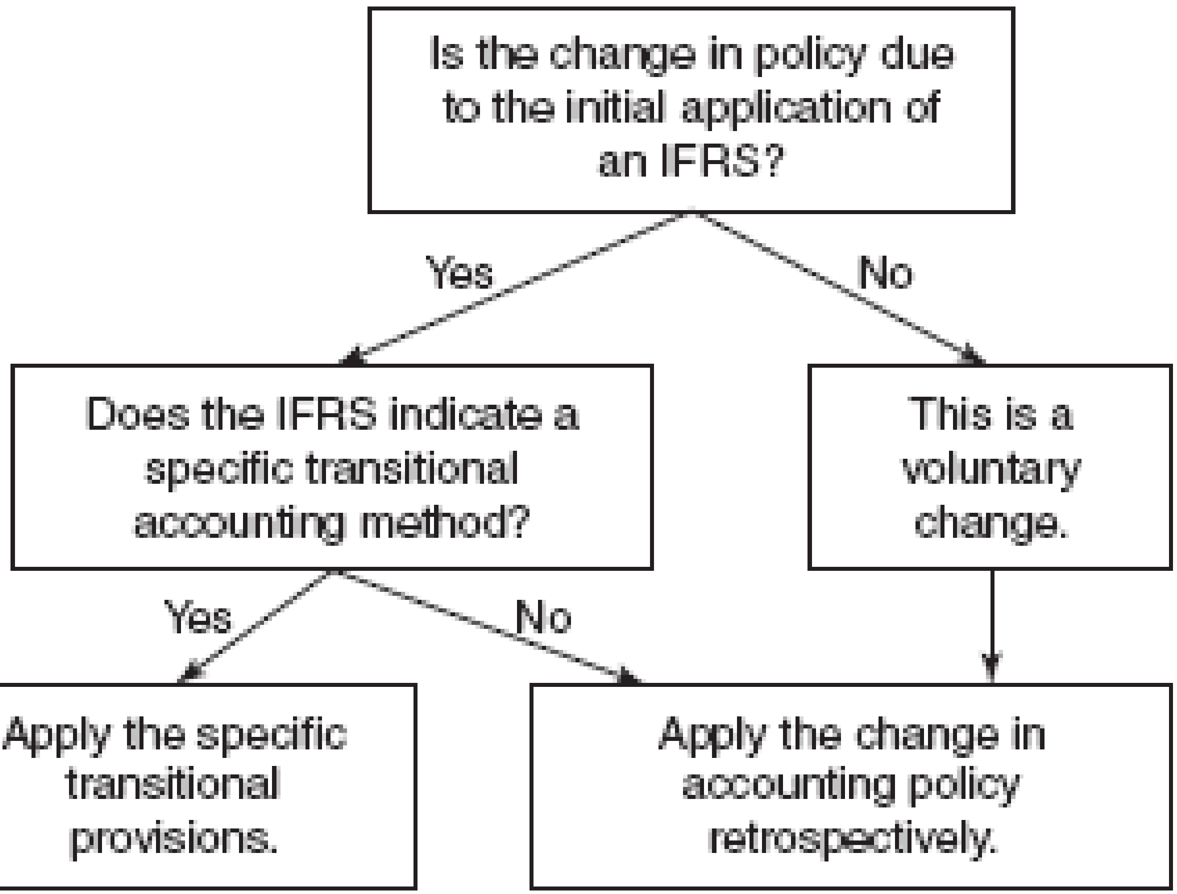
Changes in Accounting Policies

- Accounting policies -
  - "specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements"
- Source of changes in accounting policy:
  - required by a new or revised IFRS (most common)
  - voluntary change to reliable and more relevant information
- Examples

Changes in Accounting Policies

- If change due to (new information)
  - different economic conditions
  - new events or conditions
  - previously immaterial effects
- Then NOT a change in accounting policy

Changes in Accounting Policies



Changes in Accounting Policies

- Initial application of an IFRS
  - if transitional accounting method provided – follow it
  - if no transitional method – retrospective application
- Voluntary change in policy
  - retrospective application
- Retrospective (retroactive) application
  - means apply new policy as if it had always been applied
  - change past amounts

Changes in Accounting Policies

- Retrospective application:
  - for the earliest prior period presented
  - adjust opening balance of equity affected
  - adjust opening balance of other comparative amounts disclosed
- Unless
  - *impracticable* to determine effects on specific prior periods or cumulative effect of change

Changes in Accounting Policies

- **Impracticable**: not able to determine adjustments needed after making reasonable effort, i.e.,
  - effects of retroactive changes not determinable
  - assumptions needed about management's intentions in the prior period
  - cannot make estimates without knowing circumstances that existed in the prior period; can only do using hindsight
- Example: need to estimate fair value of private company three years ago. Need to know expectations that existed then re cash flows and risk-adjusted discount rate. Not possible in many situations.

Changes in Accounting Policies

- If impracticable to apply full retrospective treatment, then
  - apply the change to A, L, and equity accounts at beginning of earliest possible period for which effects are known
- If impracticable to determine cumulative effect even on current period opening balances, then
  - apply new policy prospectively

Changes in Accounting Policies

- For all changes in accounting policy, disclose
  - nature of the change
  - amounts of adjustments to all F/S items, EPS, and to prior periods
  - if judged impracticable to apply retrospectively, explain why, and how applied
- If on application of a new/revised IFRS, also report
  - name of IFRS, that transitional provisions are applied, any likely future effects
- Also disclosures about new IFRS released but not yet effective

Retrospective changes in accounting policies

- Adjust the opening balance of each effected component and any other relevant comparative amounts as if the new accounting policy had always been applied. This means that there will be a PPA to the balance of retained earnings b/f in the statement of changes in equity
- Comparative information should be restated unless impracticable to do so
- When a change in AP has a material effect on the current period or any prior period presented, or may have a material effect in subsequent periods, the following disclosures should be made:
  - Reasons for change;
  - Amount of adjustment recognised in the current period;
  - Amount of adjustment included in each period prior to those included in the FS.

Retrospective change in accounting policy

Haven Limited has traditionally valued its inventory using the weighted average method of valuation. During the year ended 31 October 2016, the directors of Haven Limited decided to change the method of inventory valuation to the FIFO method in order to give a fairer presentation of the company's results and financial position.

The reported retained earnings of Haven Limited at 31 December 2014 were Sh 2,500,000 and extracts from the company's financial statements for each of the last three year, on the basis of inventory being valued on a weighted average basis, are provided below are:

Year End	**2014**	**2015**	**2016**
Cost of sales	830,000	904,000	968,000
Profit after tax	50,000	80,000	105,000
Inventory valuation:			
Weighted Average	275,000	257,000	304,000
FIFO	296,000	294,000	365,000

Cont'd

Requirement

Based on the information provided, show how the change in inventory valuation method will be reflected in the financial statements of Raven Limited for the year ended 31 December 2012.

Solution:

Statement of Profit or Loss and Other Comprehensive Income

	2016	2015
Cost of Sales	944,000	888,000
Profit after Tax	129,000	96,000

Statement of Financial Position

	2016	2015
Current Assets		
Inventory	365,000	294,000

Solution (Cont'd):

Statement of Changes in Equity (Extract)

	Retained Earnings
	€
At start of period	2,580,000
Change in accounting policy	37,000
Restated	2,617,000
Profit for year	129,000
At end of period	2,746,000

Changes in Accounting Estimates

- *Change in accounting estimate* – adjustment to carrying amount of an A/L or amount of asset consumed in period resulting from its present status and the expected future benefits/obligations associated with it.
  - Results from new information or new developments
  - If uncertain whether a change in policy or a change in estimate, account for it as a change in estimate

Changes in Accounting Estimates

- Estimates are fundamental to the accounting process
- Changes are expected and recurring
- Therefore, account for prospectively
- Prospective application – recognize effect of change in current and future periods

Changes in Accounting Estimates

- Disclose
  - Nature of the change
  - Amount of the change, unless effect on future periods impracticable to estimate

Corrections of Errors

- *Prior period error* – an omission or misstatement in previously reported financial statements from failing to use/misuse of reliable information that
  - Was available when F/S were authorized, and
  - Could reasonably be expected to have been used in preparing those F/S
- e.g., arithmetic mistakes, mistakes in applying accounting policies, oversights, misrepresentation of facts, fraud

Corrections of Errors

- Accounting for correction of an error –
  - Retrospective restatement
  - As if error had never been made
  - If impracticable to determine period-specific adjustments, use partial retrospective application, or even prospective treatment (see change in accounting policy)

Corrections of Errors

- Disclose
  - Nature of the error
  - Amount of correction for each F/S item, EPS, and to prior periods
  - If judged impracticable to apply retrospectively, explain why, how applied and date from which error is corrected

Example

The confectionary Division of House of Manji has consistently shown an increasing profit over each of the past four years. On closer examination of the division's operating reports, Finance Director noticed that the bad debt expense and inventory obsolescence charges are not in line with the level of activity or with other divisions. This has resulted in the division paying staff cash bonuses every year.

In discussing this with the divisional accountant, the FD learned that the accountant used estimates related to the write-off of receivables and inventory to manage the division's bottom line and the amount of profit reported.

Required

Explain whether any type of accounting change is needed and, if so, how it should be accounted for.

Example

At a recent conference on financial accounting and reporting, three participants provided examples of similar accounting changes they had just encountered. They all relate to changes involving the accounting for development costs.

The first participant explained that it had recently come to her attention that capitalized product development costs incurred three years ago had not been adjusted or amortized since they were incurred. These costs should have been amortized over three years, but had been incorrectly coded and were missed in the annual adjustment process.

The second participant explained that his company was switching to a policy of expensing development costs as incurred because changing technologies were making the product life cycles so short. Previously, the company had amortized these costs over a 24- month period.

Example

The third participant also reported a change in accounting for development costs. In this case, instead of amortizing development costs on a straight-line basis over the estimated product life as in the past, her company was changing to an activity-based method. The new method charges an equal amount of development cost amortization to each inventory item produced. The change was made because the new approach better represents the benefits received from the development cost assets.

Instructions

1. Advise each participant whether the situation described is a change in accounting policy, a change in accounting estimate, or a correction of a prior period error. Explain your choice briefly.
2. Describe how each participant's situation should be accounted for and reported.

Example

In 2015, Kissii Rolling Mills recognized a Ksh 100 million loss due to a lawsuit that it appeared the company would lose. In 2016 when the judge ruled in favor of MRM position, the accountant made the following entry:

Estimated Lawsuit Liability	100	
Retained Earnings		100

To correct 2016 profit due to the outcome of the lawsuit.

Instruction

Briefly discuss the accountant's treatment of the lawsuit

Summary

- Select in accordance with IAS/IFRS or interpretation, or judgement if none available
- APs normally kept the same to ensure comparability of FS over time.
- Change when
  - Required by an IFRS – therefore follow transitional arrangements if provided, otherwise apply ***change retrospectively***
  - Voluntarily, i.e. results in better quality financial statements – therefore apply ***change retrospectively***

Notes to the financial statements

Contain information in addition to that presented in the statement of financial position, statement of comprehensive income, statement of changes in equity and statement of cash flows.

Provide narrative descriptions or dis - aggregations about items that do not qualify for recognition separately.

cross-reference each item

- to present information, including accounting policies, in a manner that provides
  - relevant,
  - reliable,
  - comparable and
  - understandable information.
- to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity’s financial position and financial performance.

Notes to the financial statements

Order:

Statement of compliance, make an explicit and unreserved statement of such compliance in the notes.

A summary of significant accounting policies applied

supporting information in the sequence in which each statement and each line item is presented; and

any other disclosures such as

- contingent liabilities,
- Un-recognized contractual commitments, and
- non-financial disclosures,
- the entity’s financial risk management objectives and policies.

Disclosure of Policies

Significant accounting policies:

- the measurement basis used in preparing the financial statements.
- the other accounting policies used that are relevant to an understanding of the financial statements.

Overall consideration

- General-purpose financial statements prepared under the accrual basis of accounting, including guidance for their structure and the minimum requirements for content.
- Fundamental principles underlying the preparation of financial statements, including
  - going-concern assumption,
  - consistency of presentation and classification,
  - accrual basis of accounting, and
  - aggregation and materiality.

Going Concern

- the management should make an assessment of the entity's ability to continue as a going concern.
- management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the reporting date.
- management may need to consider a wide range of factors relating to current and expected profitability, debt repayment schedules and potential sources of replacement financing before
- disclose that fact if financial statements not prepare on a going concern basis, the basis on which prepared the financial statements and the reason why the entity is not regarded as a going concern

Frequency of Reporting

- Present a complete set of financial statements (including comparative information) at least annually.
- If reporting period changes and the annual financial statements are presented for a period longer or shorter than one year, disclose:
  - that fact and the reason for using a longer or shorter period.
  - the fact that comparative amounts presented in the financial statements (and notes) are not entirely comparable.

Consistency of Presentation

- Retain the presentation and classification of items in the financial statements from one period to the next unless
  - it is apparent, following a significant change in the nature of the entity's operations or a review of its financial statements, that another presentation or classification would be more appropriate having regard to the criteria for the selection and application of accounting policies

Consistency of Presentation

- When the presentation or classification of items in the financial statements is changed, reclassify comparative amounts unless the reclassification is impracticable.

- When comparative amounts are reclassified, disclose
  - the nature of and the reason the reclassification.
  - the amount of each item or class of items that is reclassified.

Comparative Information

- Enhancing the inter-period comparability of information
- allowing the assessment of trends in financial information for predictive purposes.
- Details of a legal dispute whose outcome was uncertain at the end of the immediately preceding reporting
- Comparative narrative and descriptive information relevant to
- Accounting policy applied retrospectively or retrospective restatement of items or reclassifies items then present statements of financial position as at:
  - the end of the current period,
  - the end of the previous period
  - the beginning of the earliest comparative period.

Materiality and Aggregation

- Omissions or misstatements is material if they could, individually or collectively, influence the economic decisions that users make
- Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances.
- If an item is not individually material, it is aggregated with other similar items
  - Present separately each material class of similar items.
  - Present separately items of a dissimilar nature or function unless they are immaterial.
- An item that is not sufficiently material to warrant separate presentation in the statements may warrant separate presentation in the notes.

Accrual basis of accounting

- Prepare its financial statements, except for cash flow information, using the accrual basis of accounting.

- Recognises items as assets, liabilities, equity, income and expenses when they satisfy the definitions and recognition criteria

Offsetting

- offsetting detracts the ability of users both to understand the transactions, other events and conditions that have occurred and to assess the entity’s future cash flows.
  - No offsetting of assets and liabilities or income and expenses, unless required or permitted by an IFRS.
  - Offset if it reflects the substance of the transaction or other event,
- Measuring assets net of valuation allowances—for example, obsolescence allowances on inventories and doubtful debts allowances on receivables—is not offsetting.

Offset in the following cases

Other transactions that do not generate revenue net any income with related expenses arising on the same transaction.

Presents gains and losses on the disposal of non-current assets,

Net expenditure related to a provision and reimbursed under a contractual arrangement with a third party (for example, a supplier's warranty agreement) against the related reimbursement.

Presents on a net basis gains and losses arising from a group of similar transactions, for example, foreign exchange gains and losses or gains and losses arising on financial instruments held for trading.

However, an entity presents such gains and losses separately if they are material

Change of Accounting Policies/Errors

- The effects of corrections of errors and changes in accounting policies are presented as retrospective

disclosures

vary for each item:

- Items of property, plant and equipment are disaggregated into classes
- Receivables are disaggregated into amounts receivable from trade customers, receivables from related parties, prepayments and other amounts
- Inventories are disaggregated into merchandise, production supplies, materials, work in progress and finished goods;
- provisions are disaggregated into provisions for employee benefits and other items

disclosures

Each class of share capital:

- The number of shares authorised, par value per share, or that the shares have no par value;
- The number of shares issued and fully paid, and issued but not fully paid;
- A reconciliation of the number of shares outstanding at the beginning and at the end of the period;
- The rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital;

- Shares in the entity held by the entity or by its subsidiaries or associates;
- Shares reserved for issue under options and contracts for the sale of shares, including terms and amounts; and
- A description of the nature and purpose of each reserve within equity.

Fair presentation

In virtually all circumstances, an entity achieves a fair presentation by compliance with applicable IFRSs.

A fair presentation also requires selection and application of accounting policies in accordance with hierarchy of authoritative guidance that management considers in the absence of an IFRS that specifically applies to an item.

Fair presentation

Any departure from a requirement of an IFRS then disclose:

that management has concluded that the financial statements present fairly the entity's financial position, financial performance and cash flows;

that it has complied with applicable IFRSs, except that it has departed from a particular requirement to achieve a fair presentation;

- the title of the IFRS from which the entity has departed, the nature of the departure, including the treatment that the IFRS would require,
- the reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in the Framework, and the treatment adopted; and
- for each period presented, the financial effect of the departure on each item in the financial statements that would have been reported in complying with the requirement.

Judgments

future-oriented estimates are necessary to measure the recoverable amount of classes of property, plant and equipment,

the effect of technological obsolescence on inventories, provisions subject to the future outcome of litigation in progress, and

long-term employee benefit liabilities such as pension obligations

- management makes judgements in determining:
- whether financial assets are held-to-maturity investments;
- when substantially all the significant risks and rewards of ownership of financial assets and lease assets are transferred to other entities;
- whether, in substance, particular sales of goods are financing arrangements and therefore do not give rise to revenue; and
- whether the substance of the relationship between the entity and a special purpose entity indicates that the entity controls the special purpose entity.

Judgments

- To identify discontinued operations and segregate their post-tax profit or loss from the Income and expenses of continuing operations
- To assess which classification of expenses (by function or by nature) provides information that is reliable and more relevant
- To classify some expenses by function (eg the allocation of expenses that relate to more than one function of the entity)
- To classify some expenses by nature (eg to separate the components of some expenses that include items that are different in nature).

Judgements

Sources of estimation uncertainty

disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

In respect of those assets and liabilities details of:

- their nature, and
- their carrying amount as at the end of the reporting period.

Judgements

disclosures an entity makes are:

the nature of the assumption or other estimation uncertainty;

the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity;

the expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected; and

an explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved.

budget information or forecasts not required

Disclosure about Company

name of the reporting entity or other means of identification, and any change in that information from the end of the preceding reporting period;

the domicile and legal form of the entity, its country of incorporation and the address of its registered office (or principal place of business, if different from the registered office).

a description of the nature of the entity's operations and its principal activities.

Thank You

Interactive Session

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