ES

IAS 8 -ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

Presentation by: CPA Polycarp .O. Obara
Accountant Management information at KPA- Mombasa

OVERVIEW OF IAS 8

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

OBJECTIVE AND SCOPE

- To show--
  - How to select and apply accounting policies
  - How to account for changes in accounting policies
  - How to account for changes in estimates
  - How to correct errors made in the previous reporting periods.

ACCOUNTING POLICIES

- Are “specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements".

EXAMPLES-

- Basis of inventory valuation such as FIFO,Average Cost or other suitable basis as per IAS12
- Basis of measurement of fixed assets such as historical cost, fair value model ,accrual basis of financial statements.
- Timing of recognition of revenue e.t.c

ACCOUNTING POLICIES CONT.

General accounting principles:

- Accounting policies should be applied consistently over accounting periods to promote the comparability of information.
- Accounting policies may only be changed if required by IFRS or if a change in accounting policy is expected to improve the relevance and reliability of the information.

How to select accounting policies

- The question here is whether there is some IFRS or interpretation IFRIC/SIC dealing with the specific transaction event or conditions to be reported or NOT.
- IF there is some standard or interpretation, then apply it.
- But when there is NO specific standard or interpretation dealing with the transaction, event or conditions, then management needs to use judgment and develop its own policy which must provide relevant and reliable information to the users.

how to develop accounting policy

- Apply concepts from the conceptual framework for financial reporting
- Refer to other standard setting bodies' rules or standards, accounting literature and accepted industry practice in making a choice.
- Note accounting policy must be applied consistently, to all transactions within the same category or of the same type.

- **When can accounting policy be changed?**
- - When required by another IFRS.i.e.when new ifrs is issued and must be applied mandatorily.
- -When accounting policy provides better, more reliable and relevant information. This is the voluntary change of accounting policies.
- **How can accounting policies be changed?**
- If it is a new ifrs and transitional guidance is provided, follow the rules provided in the transitional guide. If there is no transitional guidance and the change is voluntary, apply the change **retrospectively** by restating every single component of equity as if the new policy had always been in place to enable comparatives.

EXCEPTIONS

- Where the effect of a change in accounting policy is not determinable for any prior period due to **impracticability**, the change in accounting policy must be accounted for **prospectively** from the start of the period in which the effect of change is determinable i.e. the change is accounted **retrospectively** to the extent that it is practicable.
- If it is not clear that the change represents a change in accounting policy or estimate, the change must be accounted for as a **revision of accounting estimate.**
- When the effect of a change in accounting policy is not material, the change may be accounted for **prospectively.**

EXCEPTIONS CONT.

- Change in accounting policy may be accounted for **prospectively** where the nature of transactions and events differ substantially from those recognized previously.
- Where non current assets are subject to the application of revaluation models under IAS16 and IAS38 for the first time ,the change in policy is accounted for **prospectively** according to those standards.

DISCLOSURE

- An entity should disclose the following (unless it is impracticable to determine the amount of the adjustment) on a change of accounting policy;
- The title of the standard;
- That the change in policy is made in accordance with any transitional provisions (if applicable);.
- The nature of the change in accounting policy;
- A description of the transitional provisions, if applicable;

DISCLOSURE CONT.

- The transitional provisions if they have an effect on future periods, if applicable;
- For current and prior periods, the amount of the adjustment for each item effected as well as its impact on EPS;
- For periods prior to those presented, the impact, if practicable; and,
- If retrospective application is impracticable, the circumstances causing that condition and how the change in policy has been applied.

ACCOUNTING ESTIMATES

- IAS 8 has not defined accounting estimate directly, but indirectly through changes in accounting estimates.
- When you change accounting estimates, you change either some amount of an asset or a liability, or pattern of an asset consumption in both current and future reporting periods.
- Accounting estimates are used by management to recognize amounts in the financial statements where precise values cannot be determined.
- **EXAMPLES: Bad** debts provisions, depreciation rates and useful lifes of assets and provision of warranty repairs e.t.c.

GENERAL PRINCIPLES:

- Using reasonable accounting estimates where precise amounts cannot be determined is essential to the preparation of reliable financial statements.
- Accounting estimates must be revised when new information becomes available.

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ACCOUNTING ESTIMATES CONT.

- **ACCOUNTING TREATMENT**:

.Accounting estimates are accounted **for prospectively**. Any change in the value of estimate is incorporated in the period in which the estimate is revised and subsequent period if necessary.

.Prior period comparative figures are unaffected by change in accounting estimate.

EXCEPTIONS:

.Where an accounting estimate has to be revised based on the information that was already available at the time of preparation of prior period financial statements, the effects of revision must be recognized **retrospectively** as it constitutes a correction of prior year error.

CHANGE IN ACOOUNTING ESTIMATE CONT.

- **DISCLOSURE**
- The nature and amount of a change in accounting estimate and its effect on both current and future periods should be disclosed unless the amount is impracticable to estimate.
- If the amount of the effect on future years is not disclosed, due to impracticality, that fact must be disclosed.

Difference between accounting policy and accounting estimate

- While accounting policy is a principle or rule, or a measurement basis, accounting estimate is the amount determined based on selected basis or some pattern of future consumption of the asset.
- Example, choice of fair value vs. historical cost is a choice in accounting policy, but updating provision based on fair value change is change in accounting estimate
- While change in accounting policy is accounted for retrospectively, change in accounting estimate is accounted for prospectively.

ACCOUNTING ERRORS

- **Accounting errors are** the omissions from and misstatements in financial statements resulting from the misuse or disregard of reliable information that was either available at the time of preparation of financial statements or could be reasonably expected to have been obtained at that time.
- **Example**

- Mathematical errors.
- Omissions and mistakes in transactions, balances and disclosures of financial statements.
- Misapplication of IFRS and GAAP.
- Incorrect classification of transactions and balances.

ACCOUNTING FOR ERRORS CONT.

- . **Accounting Treatment**
- Current period errors discovered during the period should be corrected before the financial statements are issued.
- Prior period errors must be corrected **retrospectively**, i.e. prior period comparative figures must be restated as if no errors were previously reported.

EXCEPTIONS

- Where a prior period error is not material, it may be corrected **prospectively.**
- Where the effect of an accounting error is not determinable for any prior period due to the reason of **impracticability,** the prior period error may be corrected **prospectively** from the start of the period in which the effect of the error is determinable. In other words, the prior period error is corrected **retrospectively** to the extent that it is practicable.

DISCLOSURE OF PRIOR PERIOD ERRORS

. The nature of the prior period error.

. For each prior period presented, to the extent practicable, the amount of the correction for each line item affected and for EPS.

. The amount of the correction at the start of the earliest period presented.

.If retrospective application is impracticable, the circumstances that led to the existence of that condition and a description of how and from when the error has been corrected.

- This is only required in the year of discovery. It is not required in future years.

Example - Change in Accounting Policy IAS 8

ABC LTD until now has valued inventory using LIFO method. However, following changes to IAS 2 *Inventories*, the use of LIFO method has been disallowed. Therefore, management of the company intends to use FIFO method for the valuation of the company's stock.

Following are extracts of ABC LTD's most recent financial statements before the application of FIFO method.

Statement of Financial Position as at 31 December 20X2		
	20X2 $M	20X1 $M
Current Assets:		
Cash and Bank	6	4
Short Term Investments	5	8
Inventory	10	12
	21	24

Income Statement for the year ended 31 December 20X2		
	20X2 $M	20X1 $M
Cost of Sales:		
Opening Inventory	12	8
Purchases	48	44
Closing Inventory	(10)	(12)
	50	40

Statement of Changes in Equity for the year ended 31 December 20X2		
	20X2 $M	20X1 $M
Retained Earnings:		
Opening Reserves	40	30
Net Profit	30	20
Dividend	(10)	(10)
Closing Reserve	60	40

Accounting Treatment

The switch from LIFO method to FIFO method represents a change in accounting policy which must be accounted for retrospectively in the financial statements. Therefore, the change must be applied as if the new accounting policy was always in place.

Consequently, entity shall adjust all comparative amounts presented in the financial statements affected by the change in accounting policy for each prior period presented.

Management estimates that the value of its inventory using FIFO method would be as follows:

	20X2 $M	20X1 $M	20X0 $M
Inventory	12	13	10

Example

Management further believes that the valuation of inventory using FIFO method for periods prior to 20X0 would produce materially similar results.

The financial statement extracts of ABC LTD would appear as follows after the retrospective application of the change in accounting policy.

Statement of Financial Position as at 31 December 20X2		
	20X2 $M	20X1 $M
Current Assets:		
Cash and Bank	6	4
Short Term Investments	5	8
Inventory	12	13
	23	25

The amount of inventory is adjusted for current period as well as the prior period.

Example

Income Statement for the year ended 31 December 20X2		
	20X2 $M	20X1 $M
Cost of Sales:		
Opening Inventory	13	10
Purchases	48	44
Closing Inventory	(12)	(13)
	49	41

Example

Statement of Changes in Equity for the year ended 31 December 20X2		
	20X2 $M	20X1 $M
Retained Earnings:		
Opening Reserves	40	31
Net Profit	31	19
Dividend	(10)	(10)
Closing Reserve	61	40

Example

- Note that the change is applied to both current period and prior period comparative amounts presented (i.e. retrospectively). The estimated effect of the change in accounting policy relating to the prior periods that are not presented (i.e. before 20X1) is adjusted in the opening reserves of 20X1.
- The nature of the change in accounting policy must be disclosed in the financial statements of ABC LTD.
- The example is for illustration purpose only and is just a simplified view of how a change in accounting policy is accounted for. In practice, the effects of changes in accounting policy may be hard to determine. Transitional provisions for adoption of policies specified by new standards must also be considered when applying a change in accounting policy due to changes in the requirements of the reporting standards.

Example

- ABC LTD has depreciated a machine over its expected useful life of 5 years. The cost of machine was $100,000 and annual depreciation charge was therefore $25,000. No residual value is expected at the end of the machine's useful life.
- Three years later, the remaining useful life of the machine was estimated to be only 1 years.
- ABC LTD should account for the change in estimate prospectively by allocating the net carrying amount of the asset over its remaining useful life. No adjustment is required to restate the depreciation charge in previous accounting periods.
- Depreciation expense for the machine would therefore be as follows:

Example

	Depreciation Expense	Accumulated Depreciation	Working
Year 1	20,000	20,000	(100,000/5)
Year 2	20,000	40,000	(80,000/4)
Year 3	30,000	70,000	(60,000/2)
Year 4	30,000	100,000	(30,000/1)

Although expected useful life of the machine has reduced at the end of third year, depreciation expense recorded in previous years is not affected. Instead, the depreciation expense is increased accordingly in years 3 and 4.

Example

Example - Correction of Prior Period Accounting Errors IAS 8

Management of ABC LTD, while preparing financial statements of the company for the period ended 31st December 20X2, noticed that they had failed to account for depreciation in last year's accounts in respect of an office building acquired in the preceding year.

Example

Following are extracts of ABC LTD's most recent financial statements before the application of FIFO method.

Statement of Financial Position as at 31 December 20X2		
	20X2 $M	20X1 $M
Non Current Assets:		
Cost	50	50
Accumulated Depreciation	10	8
	40	42

Example

Income Statement for the year ended 31 December 20X2		
	20X2 $M	20X1 $M
Administration Expenses:		
Depreciation	2	1

Statement of Changes in Equity for the year ended 31 December 20X2		
	20X2 $M	20X1 $M
Retained Earnings:		
Opening Reserves	40	30
Net Profit	30	20
Dividend	(10)	(10)
Closing Reserve	60	40

Accounting Treatment

The omission of depreciation of office building in the previous year's financial statements represents a **prior period accounting error** which must be accounted for **retrospectively** in the financial statements. Consequently, ABC LTD shall adjust all comparative amounts presented in the current period's financial statements affected by the accounting error.

Management estimates that depreciation charge for the year 20X1 was under booked by $1 million.

Financial statement extracts of ABC LTD would appear as follows after the retrospective correction of the prior period accounting error.

Statement of Financial Position as at 31 December 20X2		
	20X2 $M	20X1 $M
Non Current Assets:		
Cost	50	50
Accumulated Depreciation	11	9
	39	41

Example

Income Statement for the year ended 31 December 20X2		
	20X2 $M	20X1 $M
Administration Expenses:		
Depreciation	2	2

Statement of Changes in Equity for the year ended 31 December 20X2		
	20X2 $M	20X1 $M
Retained Earnings:		
Opening Reserves	39	30
Net Profit	30	19
Dividend	(10)	(10)
Closing Reserve	59	39

Example

Note that the correction of the error is applied to all prior period comparative amounts affected by the omission (i.e. retrospectively). Current year's profit is therefore unaffected by the correction of prior period error.

The nature of the correction of prior period error must be disclosed in the financial statements of ABC LTD.

IAS 8 Assessment Quiz | Part I

Question 1

You are a senior accountant at ABC LTD.

While proof-reading financial statements for the year ended 30 June 2014, Liza, a trainee accountant, has identified certain changes from last year's financial statements but she is unsure whether they represent a change in accounting policy, a revision in accounting estimate or a correction of prior-period error.

Identify whether the following constitute a change in accounting policy, a revision in accounting estimate or a correction of prior-period error.

a) Previously, ABC LTD accounted for its non-current assets using the historical cost basis.

In the current period, however, ABC LTD has adopted the revaluation model of IAS 16 to account for its non-current assets.

Change in Accounting Policy

Revision of Accounting Estimate

Correction of Prior-Period Error

Correct answer is **Change in Accounting Policy.**

Basis of measurement of the elements of financial statements (e.g. historical cost, fair value, etc.) represent accounting policies.

Example

Any change in the basis of measurement therefore constitutes a change in accounting policy.

b) ABC LTD previously had a policy of calculating depreciation on equipment using the straight line method @ 10%.

However, In light of significant losses recognized on recent disposals the management has decided to depreciate equipment by using the reducing balance method @ 20% which shall more accurately reflect the wear and tear of equipment.

Change in Accounting Policy

✓

Revision of Accounting Estimate

✓

Correction of Prior-Period Error

✓

Correct Option is **Revision of Accounting Estimate.**

Change in the depreciation method merely reflects a shift in the management's expectation of the pattern of periodic consumption of equipment and therefore represents a revision in accounting estimate.

Example

c) ABC LTD has a policy of valuing inventory using the FIFO method.

Liza noticed the value of inventory brought forward in the current period (i.e. last year's closing inventory balance) has been changed because it had erroneously been valued using the LIFO method last year.

Change in Accounting Policy

✓

Revision of Accounting Estimate

✓

Correction of Prior-Period Error

✓

Correct Option is **Correction of Prior-Period Error.**

Misapplication of an accounting policy represents an accounting error.

The restatement of last year's closing inventory in current period financial statements therefore represents a correction of prior-period error rather than a change in accounting policy or estimate.

Example

d) ABC LTD has a past practice of recognizing sales revenue at the time of dispatch of goods to the retailers.

In the current period, however, sales revenue has not been recognized by ABC LTD until the goods sold to retailers have been re-sold to the end-consumers.

Management believes the new recognition rule more accurately reflects the economic substance of the sales and returns arrangement with retailers.

Change in Accounting Policy

✓

Revision of Accounting Estimate

✓

Correction of Prior-Period Error

✓

Correct Option is **Change in Accounting Policy.**

Variation in rules and practices used in the preparation of financial statements represents a change in accounting policy.

Example

e) In estimating the employee benefits obligations of ABC LTD at the previous year end, the actuary failed to take into account ABC LTD's plan to discontinue operations in one of its geographic segments. Management had announced its plan three years ago.

Recently, the actuary furnished revised estimates of ABC PLC's liability with respect to employee benefits of the current and prior periods taking into account the plans for discontinuation.

Financial statements of this year have been amended accordingly.

Change in Accounting Policy

✓

Revision of Accounting Estimate

✓

Correction of Prior-Period Error

✓

Correct Option is **Correction of Prior-Period Error.**

Failing to consider material information while developing estimates that was already available at that time constitutes an accounting error.

Example

IAS 8 Assessment Quiz | Part II

Question 1

You are the Chief Accountant at DEF PLC.

Steve, the Accounts Officer, has brought to you the following matters for an assessment of their impact on the financial statements for the year ended 30 June 2014 which are in the process of being finalized.

Determine the amounts to be recognized in respect of the following transactions and balances for the current period as well as the prior period comparative s to be reported in the financial statements for the year ended 30 June 2014.

a) DEF PLC has been valuing inventory on the basis of Average Cost Method (AVCO) until 30 June 2013.

DEF PLC is involved in a seasonal business and the use of AVCO method dilutes the effect of seasonal fluctuation on the cost of inventory.

Management believes FIFO Method will provide more relevant information regarding the value of inventory held by DEF PLC and has decided to apply it for the first time starting from the current period.

Value of inventory calculated using the two basis is as follows:

	As at 30 June '14	As at 30 June '13
FIFO	$275,000	$250,000

Example

a) Current Year End b) Comparative Year End

As at 30 June '14	As at 30 June '13
$275,000	**$250,000**
✓	✓
$300,000	**$200,000**
✓	✓

	30 June '14	30 June '13
Correct Answer:	$275,000	$250,000

Change in inventory valuation method constitutes a change in the accounting policy.

A change in accounting policy is acceptable where it results in the presentation of more relevant and reliable financial statements.

As per IAS 8, the change is applied retrospectively whereby the prior period comparative figure of inventory balance should be restated in accordance with the new valuation method.

Example

b) Last year, DEF PLC was involved in a litigation.

The litigation against the Company was in progress in a civil court at the time of issuance of the financial statements for the year ended 30 June 2013 and a disclosure was included to this effect. No liability had been recorded however since the Company's legal advisors firmly believed in a favorable outcome.

As per the expectation of the legal advisors, the Company won the case in civil court this year. However, the decision of the civil court was subsequently overturned by the High Court and the Company was forced to pay $500,000 to the claimants on 31 May 2014.

What amount of liabilities, if any, should be reported in respect of the legal claim in the financial statements under consideration for:

a) Current Year End As at 30 June '14	b) Comparative Year End As at 30 June '13
Nil	**Nil**
$500,000	**$500,000**

	30 June '14	30 June '13
Correct Answer:	Nil	Nil

The adverse decision of the Court and the resulting liability merely shows that the management's estimate regarding the likely outcome of the litigation was incorrect.

Hindsight cannot be used to classify this occurrence as a prior period error which is why the comparative figures need not be restated.

As the claim was settled during the current period, no liability will be presented at the current year end either.

Example

c) DEF PLC acquired a factory on 1 July 2012 for $1,000,000.

In the last accounting period, DEF PLC depreciated the factory building on straight line basis assuming a useful life of 10 years.

In the current period, the useful life of the factory premises has been revised to 20 years instead of 10 years assessed last year.

Amounts of depreciation expense calculated using the different assumptions are as follows:

Net Book Value	Useful Life	Depreciation Expense
$1,000,000	10 years	$100,000
$1,000,000	20 years	$50,000
$900,000	19 years	$47,368
$950,000	19 years	$50,000

What amount of depreciation expense should be presented in the financial statements under consideration for:

Example

a) Current Year End As at 30 June '14	b) Comparative Year End As at 30 June '13
$100,000	**$100,000**
✓	✓
$50,000	**$50,000**
✓	✓
$47,368	**$47,368**
✓	✓

	30 June '14	30 June '13
Correct Answer:	$47,368	$100,000

The revision of the useful life of factory premises represents a change of estimate.

Prospective application requires that the effect of the revision should be accounted for in the current and future accounting periods.

However, depreciation already charged in the previous accounting period (i.e. $100,000) need not be restated.

Example

d) DEF PLC has a policy of recognizing revenue upon the sale of their goods by its distributors to the retailers.

This year has been particularly hard for the Company's business. In order to improve the profitability of DEF PLC, Steve has suggested recognizing sales revenue upon the delivery of goods to the Company's distributors instead of delaying it until the sales are made to retailers.

Comparison of the sales revenue using the different revenue recognition policies is as follows:

	Sales for the current year ended 30 June '14	Sales for the comparative year ended 30 June '13
Old policy	$2,500,000	$3,000,000
New policy	$3,500,000	$2,800,000

What amount of revenue should be presented in the financial statements under consideration for:

a) Current Year End As at 30 June '14	b) Comparative Year End As at 30 June '13
$2,500,000	$3,000,000
$3,500,000	$2,800,000

	30 June '14	30 June '13
Correct Answer:	$2,500,000	$3,000,000

Accounting policies should be applied consistently over the period of time to promote comparability of information presented in the financial statements.

Accounting policies cannot be changed unless required by the IFRS or if it leads to more relevant and reliable financial statements.

Further, accounting policies cannot be changed merely for achieving a desired

Example

IAS 8 Assessment Quiz | Part III

You are the Chief Accountant at EFG PLC.

Clark, a Senior Accountant, has brought to your attention some matters for consideration of their impact on the financial statements for the year ended 30 June 2014 before they are issued to public.

Suggest the amounts to be recognized in respect of the following transactions and balances for current year as well as the prior year comparatives to be reported in the financial statements for the year ended 30 June 2014.

a) EFG PLC has been valuing its buildings on the historical cost basis until last year.

From the current period, management has planned to apply the revaluation model of IAS 16 to account for its buildings.

The carrying values of buildings calculated using the two basis of valuation are as follows:

	As at 30 June '14	As at 30 June '13
Historical Cost	$800,000	$900,000
Revalued Cost	$2,700,000	$2,200,000

What carrying values of buildings should be presented in the Statement of Financial Position as at 30 June 2014 for:

Example

a) Current Year End	b) Comparative Year End
As at 30 June '14	As at 30 June '13
$800,000	**$900,000**
✓	✓
$2,700,000	**$2,200,000**
✓	✓

	30 June '14	30 June '13
Correct Answer:	$2,700,000	$900,000

The retrospective application of a change in accounting policy under IAS 8 does not apply to the initial change from historical cost basis to revaluation model under IAS 16 and IAS 38.

Consequently, EFG PLC must report the prior period comparative balance of buildings on historical cost basis.

Example

b)

EFG PLC has changed its accounting policy for recognition of revenue during the current period.

The balance of retained earnings, as reported in the statement of changes in equity in last year's financial statements are as follows:

Balance at 30 June 2011 $50,000

Balance at 30 June 2012 $70,000

Balance at 30 June 2013 $100,000

Profit before tax for the current year ended 30 June 2014 is $40,000 accounted for in accordance with the new revenue recognition policy.

The effect of change in accounting policy on revenue recognized in previous accounting periods is as follows:

Year End Value	Increase (Decrease) in Revenue
30 June '13	$10,000
30 June '12	($25,000)
30 June '11	$5,000

The effect of change in revenue recognition policy is determinable till the accounting year ended 30 June 2011 prior to which the computation of the effect of change is impracticable.

Tax rate is 20%.

Example

What amounts of retained earnings should be reported the statement of changes in equity in the financial statements under consideration for:

Balance at 30 June 2012 $

Balance at 30 June 2013 $

Balance at 30 June 2014 $

Submit

c) c) EFG PLC acquired an equity investment in an unquoted company on 1 July 2012 which it values on the basis of its fair value.

Last year, the fair value of the investment as at 30 June 2013 was estimated to be $20,000 by an actuary.

This year, the actuary estimated a fair value of $25,000 as at 30 June 2014. However, the actuary asserted that he had used a different estimation technique this year in arriving at the fair value and that if he had used the same estimation method last year, the fair value of the investment would have been $18,000 as at the 30 June 2013.

It is difficult to conclude whether the change in estimation technique used in determination of the fair value of investment constitutes a change in accounting policy or estimate.

What value of investment should be presented in the financial statements under consideration for:

a) Current Year End b) Comparative Year End

As at 30 June '14	As at 30 June '13
$25,000	**$20,000**
✓	✓
$23,000	**$18,000**
✓	✓

	30 June '14	30 June '13
Correct Answer:	$25,000	$20,000

IAS 8 requires that in cases where it is hard to differentiate between a change in policy and a change in estimate, the change is accounted for prospectively. Consequently, the comparative value of the investment need not be restated in the current financial statements.