IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors

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Examiner: Formation 2 Financial Accounting

Accounting Policies
Accounting policies are the significant principles, bases, conventions, rules and practices applied by an entity in preparing and presenting the financial statements.

An entity determines its accounting policies by applying the International Accounting Standards Board's (IASB) Standards and Interpretations.

In the absence of a Standard or Interpretation covering a specific transaction, other event or condition, management uses its judgement to develop an accounting policy which results in information that is relevant and reliable, considering in the following order.

- Standards or Interpretations dealing with similar and related issues;
- The Framework definitions and recognition criteria; and
- Other national GAAPs based on a similar conceptual framework (providing the treatment does not conflict with extant Standards, Interpretations or the Framework).

Changes in accounting policy
The general rule is that accounting policies are normally kept the same from period to period to ensure comparability of financial statements over time.

A change in accounting policy is made only if:
- a) it is required by a Standard or Interpretation; or
- b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

A change in accounting policy occurs if there has been a change in:

- recognition e.g. an expense is now recognised rather than an asset
- presentation e.g. depreciation is now included in cost of sales rather than administrative expenses
- measurement basis e.g. stating assets at replacement cost rather than historical cost
Accounting treatment
Where the initial application of a standard/interpretation does not prescribe specific transitional provisions, an entity applies the change retrospectively by

a) restating comparative amounts for each prior period presented as if the accounting policy had always been applied;
b) adjusting the opening balance of each affected component of equity for the earliest prior period presented;
c) including the adjustment to opening equity as the second line of the statement of changes in equity; and
d) disclosing the nature of the change and the amount of the adjustment to current and prior periods for each line item in each period affected.

Where it is impracticable to determine the period-specific effects, the entity applies the new accounting policy from the earliest period for which retrospective application is practicable (and discloses that fact).

Key disclosures
a) the nature of the change in accounting policy
b) the reasons for the change
c) the amount of the adjustment for the current and each prior period presented for each line item affected
d) the amount of the adjustment to periods before those presented.

Example 1:

Which one of these changes would be classified as a ‘change in accounting policy’ as determined by IAS 8?

A Increased the allowance for doubtful debts from 6% to 8% of outstanding debts
B Changed the method of valuing inventory from weighted average cost to first in first out
C Changed the depreciation of plant and equipment from reducing balance to straight line depreciation on cost
D Changed the useful economic life of its plant and equipment from six years to eight years

Solution:

B A change in the method of inventory valuation would be classified as a change in accounting policy under IAS 8. The allowance for doubtful debts, change in useful life and depreciation methods are all accounting estimates.
Example 2:

In which two of the following situations can a change in accounting policy be made by an entity?

A If a new accounting policy would show more favourable results
B If a new accounting policy results in a more reliable and relevant presentation of events or transactions
C If the change is required by an IFRS
D If the company thinks a new accounting policy would be easier to report

Solution:

B + C A change in accounting policy may be made firstly if this is required by an IFRS (mandatory change). If there is no requirement, a company can choose to change their accounting policy if they believe a new accounting policy would result in a more reliable and relevant presentation of events and transactions.

Companies cannot change their accounting policies simply to make financial reporting easier, or to try and show a more favourable picture of results.

Example 3:

Which two circumstances are outlined in IAS 8 as acceptable reasons to change accounting policy?

A To show the best possible results for shareholders
B If a change results in more reliable and relevant information to users
C If tax law in a country changes
D If required by an IFRS

Solution:

B +D Accounting policies should only be changed if doing so results in the production of more reliable and relevant information or if required by a new international financial reporting standard.

Changes in Accounting Estimates

A change in accounting estimate is an adjustment of the carrying amount of an asset or liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities.

An accounting estimate is a method adopted by an entity to arrive at estimated amounts for the financial statements.
Most figures in the financial statements require some estimation:

- the exercise of judgment based on the latest information available at the time
- at a later date, estimates may have to be revised as a result of the availability of new information, more experience or subsequent developments.

Changes in accounting estimates result from new information or new developments and, accordingly, are not correction of errors.

Examples of estimates that may change include

- allowances for doubtful debts
- useful lives/expected pattern of consumption of depreciable assets; and
- warranty obligations.
- the method of depreciating non-current assets;
- inventory obsolescence;

Changes in accounting estimates are applied prospectively, i.e. in the current period (and future periods if the change affects both current and future periods).

When it is difficult to distinguish a change in accounting policy from a change in accounting estimate, the change is treated as a change in accounting estimate.

The nature and amount of changes in accounting estimates that affect current and/or future periods must be disclosed.

**Example 4:**

A piece of property, plant and equipment cost €24,000 and it is to be written off over eight years and it can be written off using different depreciation methods such as straight line, reducing balance, sum of the digits, etc.

Which of the above relates to the accounting policy and which relates to a change in accounting estimates?

**Solution:**

The choice of method of depreciation would be the estimation technique whereas the policy of writing off the cost of non-current assets over their useful life would be the accounting policy.

Estimation techniques therefore implement the measurement aspects of accounting policies.
Example 5:
Which of the following would be a change in accounting policy as per IAS 8?

A A change in reporting depreciation charges as distribution costs rather than as administrative expenses
B Depreciation charged on reducing balance method rather than straight line on cost
C Reducing the value of inventory from cost to net realisable value due to a valid adjusting event after the reporting period

Solution:
A Item B is an accounting estimate and Item C is applying the same policy as previously, with a correction to the figure used.

Example 6 – Accounting policies versus accounting estimates:
Which of the following is a change in accounting policy as opposed to a change in estimation technique?

A An entity has previously shown depreciation within cost of sales. It now shows those overheads within administrative expenses.
B An entity has previously measured inventory using the first in first out method and it now intends to measure inventory using the weighted average cost method.
C An entity has previously depreciated vehicles using the straight line method and now intends to switch to the reducing balance method

Solution:
For each of the items, ask whether this involves a change to:
- Recognition
- Presentation
- Measurement basis

If the answer to any of these is yes, the change is a change in accounting policy.

A This is a change in presentation and therefore, a change in accounting policy.
B This is a change in measurement basis and therefore a change in accounting policy.
C This is a change in estimation technique only.
Example 7:

Which of the following is a change in accounting policy as opposed to a change in accounting estimate?

A  Classifying commission earned as revenue in the SOPL having previously classified it as other operating income
B  Revising the remaining useful life of a depreciable asset

Solution:

A  A change in accounting policy under IAS 8.
B  A change in accounting estimates.

Prior Period Errors
Prior period errors are omissions from, and misstatements in, the entity’s financial statements for one or more prior periods arising from a failure to use, or misuse of reliable information that:

a) was available when the financial statements for those periods were authorised for issue; and
b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

They may arise from
a) mathematical mistakes
b) mistakes in applying accounting policies
c) oversights
d) misinterpretation of facts
e) fraud.

Accounting treatment
An entity corrects material prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery by:

a) restating comparative amounts for each prior period presented in which the error occurred;
b) (if the error occurred before the earliest prior period presented) restating the opening balances of assets, liabilities and equity for the earliest prior period presented,
c) including any adjustment to opening equity as the second line of the statement of changes in equity; and
d) disclosing the nature of the error and the amount of the correction to prior periods for each line item in each period affected.

Where it is impracticable to determine the period-specific effects or the cumulative effect of the error, the entity corrects the error from the earliest period/date practicable (and discloses that fact).
Key disclosures
   a) the nature of the prior period error
   b) the amount of the correction for each prior period presented for each line item affected
   c) the amount of the correction at the beginning of the earliest prior period presented.

Example 8 – Prior Period Errors:

During 2019, a company discovered that certain items had been included in inventory at 31 December 2018 at a value of €1 million but they had in fact been sold before the year-end.

The original figures reported for the year ended 31 December 2018 and the figures for the current year 2019 are given below:

<table>
<thead>
<tr>
<th></th>
<th>2019</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>€'000</td>
<td>€'000</td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>50,000</td>
<td>47,000</td>
</tr>
<tr>
<td>Cost of Sales</td>
<td>32,000</td>
<td>31,000</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>18,000</td>
<td>16,000</td>
</tr>
<tr>
<td>Tax</td>
<td>3,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Net Profit</td>
<td>15,000</td>
<td>14,000</td>
</tr>
</tbody>
</table>

The cost of sales in 2019 includes the €1 million error in opening inventory.

Required: Show the 2019 SOPL with comparatives figures.

Solution

Statement of Profit or Loss

<table>
<thead>
<tr>
<th></th>
<th>2019</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>€'000</td>
<td>€'000</td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>50,000</td>
<td>47,000</td>
</tr>
<tr>
<td>Cost of Sales</td>
<td>32,000</td>
<td>31,000</td>
</tr>
<tr>
<td>2019 (32,000 - 1,000)</td>
<td>31,000</td>
<td></td>
</tr>
<tr>
<td>2018 (31,000 + 1,000)</td>
<td>32,000</td>
<td></td>
</tr>
<tr>
<td>Gross Profit</td>
<td>19,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Tax</td>
<td>3,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Net Profit</td>
<td>16,000</td>
<td>13,000</td>
</tr>
</tbody>
</table>
Example 9:

According to IAS 8, how should a material error in the previous financial reporting period be accounted for in the current period

A  By making an adjustment in the financial statements of the current period as a movement on reserves and disclosing the nature of the error in a note
B  By making an adjustment in the financial statements of the current period through the SOPL and disclosing the nature of the error in a note
C  By restating the comparatives amounts for the previous period at their correct value and disclosing the nature of the error in a note
D  By restating the comparative amount for the previous period at their correct value, but without the requirement for a disclosure of the nature of the error in a note

Solution:

C  The prior period error is corrected by restating the comparative amounts for the previous period at their correct value. A note to the accounts should disclose the nature of the error together with other details.