IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors – A Closer Look

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International Accounting Standard (IAS) 8, *Accounting Policies, Changes in Accounting Estimates and Errors* (IAS 8) is concerned with three separate aspects of performance, all of which affect the income statement and the measurement of profit. In October 1976, the International Accounting Standards Committee (IASC) issued the Exposure Draft E8, *The Treatment in the Income Statement of Unusual Items and Changes in Accounting Estimates and Accounting Policies.* In February 1978, the IASC issued IAS 8, *Unusual and Prior Period Items and Changes in Accounting Policies.* In July 1992, the IASC issued Exposure Draft E46, *Extraordinary Items, Fundamental Errors and Changes in Accounting Policies* as part of the 'Comparability of Financial Statements' project based on E32. Based on the comments received, the IASC issued revised IAS 8, *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies* in December 1993, which supersedes 1978 version of IAS 7. The effective date was fixed as January 1, 1995. On December 18, 2003, the International Accounting Standards Board (IASB) issued the revised version of IAS 8, effective from January 1, 2005. It replaces former IAS 8 (Revised 1993) and Standing Interpretations Committee (SIC) Interpretations SIC 2 *Consistency - Capitalisation of Borrowing Costs* and SIC 18 *Consistency - Alternative Methods.*

Objective

The objective of IAS 8 is to prescribe the criteria for selecting, applying and changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and the corrections of errors. IAS 8 is intended to enhance the relevance and reliability of an entity's financial statements, and the comparability of those financial statements over time and with the financial statements of other entities.

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Scope and Application

IAS 8 should be applied in selecting and applying accounting policies, and accounting for changes in accounting policies, changes in accounting estimates and corrections of prior period errors. The tax effects of corrections of prior period errors and of retrospective adjustments made to apply changes in accounting policies are accounted for and disclosed in accordance with IAS 12, *Income taxes*.

Definitions

Accounting Policies: The specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.
Change in Accounting estimate: An adjustment to the carrying amount of an asset/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. They result from new information or new developments and are not correction of errors.
Impracticable: A situation where the entity cannot apply a requirement after making every reasonable effort to do so. The definition further states that for a particular period it is impracticable to apply a change in accounting policy retrospectively or to make a retrospective restatement to correct an error if:
• the effects are not determinable
• the restatement requires an assumption as to management's intent
• the restatement requires significant estimates of amounts which are impossible to objectively estimate.
International Financial Reporting Standards (IFRSs): The standards and interpretations adopted by the IASB. They comprise: IFRSs; IASs and Interpretations developed by the International Financial Reporting Interpretations Committee (IFRIC) or the former SIC and approved by the IASB.
Materiality: Omissions or misstatements of items are material if they could, by their size or nature, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements.
Prior Period Errors: Omissions from, and misstatements in, an entity's financial statements for one or more prior periods due to a failure to use, or misuse of, reliable information that:
(a) was available when financial statements for those periods were authorised; and
(b) could have reasonably be obtained and taken into account when preparing and presenting those financial statements. Such errors result from mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.
Prospective application: A change in an accounting estimate is recognising the effect in the current and future periods affected by the change.
Retrospective application: Applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied.

Prescribed Accounting Treatment

The main requirements of IAS 8 include:

• accounting policies are determined by applying the IFRS that addresses a specific issue

• in the absence of an IFRS, the development of an accounting policy shall be based on providing relevant and reliable information. Primary consideration is given to IFRSs dealing with similar and related issues and then followed by the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the *Framework*. The most recent pronouncements of other standard setting bodies may be consulted as long as they use a similar conceptual framework and do not conflict with any of the IASB's pronouncements

• accounting policies are to be applied consistently to similar transactions, events and conditions unless an IFRS provides otherwise

• a change in accounting policy upon the initial adoption of an IFRS is made in accordance with the specific transitional provisions in that standard. Where there are no transitional provisions, the standard is applied retrospectively unless it is impracticable to do so

• voluntary changes in accounting policy are only to be made if they provide more relevant and reliable information and are accounted for retrospectively unless it is impracticable to do so

• changes in accounting estimates (such as inventory obsolescence, or a change in the useful life of assets) shall be accounted for prospectively

• prior period errors are corrected by restating comparative information and opening retained earnings of the earliest prior period presented unless it is impractical to do so

Accounting policies

Selection and Application of Accounting Policies

When a Standard or an Interpretation specifically applies to a transaction, other event or condition, the accounting policy or policies applied to that item must be determined by applying the Standard or Interpretation and considering any relevant Implementation Guidance issued by the IASB for the Standard or Interpretation.

In the absence of a Standard or an Interpretation, management must use their judgement in developing and applying an accounting policy that results in information that is:
(a) relevant to the economic decision making needs of users; and
(b) reliable as it purports faithfully the financial statements, reflects their substance, is neutral, prudent and complete in all material respects.

In making the judgement, management must refer to, and consider the applicability of, the following sources in descending order:

(a) the requirements and guidance in Standards and Interpretations dealing with similar and related issues; and

(b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the *Framework*.

Management must consider the IFRSs etc first and then the *Framework* in deciding the most appropriate policies. They are also encouraged to look to other standard setters having the same framework, accounting literature and accepted industry practice in making their choice.

Consistency of Accounting policies

An entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions, unless a Standard or an Interpretation specifically requires or permits categorisation of items for which different policies may be appropriate. If a Standard or an Interpretation requires or permits such categorisation, an appropriate accounting policy shall be selected and applied consistently to each category.

Changes in Accounting Policies

An entity is permitted to change an accounting policy only if the change:

(a) is required by a Standard or an Interpretation; or
(b) results in financial statements providing more reliable and relevant information about the effects of transactions on the entity's financial position, financial performance or cash flows.

The following are not changes in accounting policies:
(a) the application of accounting policies for transactions that differ in substance from those previously undertaken; and
(b) the application of a new policy that did not occur previously or were immaterial.

Applying changes in accounting policy

On first application of a standard the change must be applied retrospectively unless specific transitional arrangements in the IFRS/IAS apply.

Opening reserves should be adjusted for the earliest prior period presented as if new policy had always applied (retrospective application).

If impracticable to apply retrospective application to prior period the entity should apply the new policy to the carrying amounts of assets and liabilities as at the start of the earliest period for which retrospective application is practicable. That may be the current period.

Disclosures Relating to Changes in Accounting Policies

An entity should disclose the following (unless it is impracticable to determine the amount of the adjustment) on a change of accounting policy:
(a) the title of the standard or interpretation causing the change;
(b) that the change in policy is made in accordance with any transitional provisions (if applicable).

(c) The nature of the change in accounting policy
(d) A description of the transitional provisions, if applicable
(e) The transitional provisions if have an effect on future periods, if applicable
(f) For current and prior periods, the amount of the adjustment for each item effected as well as impact on EPS.
(g) For periods prior to those presented, the impact, if practicable
(h) If retrospective application is impracticable, the circumstances causing that condition and how change in accounting policy has been applied.

When a voluntary change in policy affects the current or any prior period but it is impracticable to determine its amount an entity should disclose:
(a) the nature of the change in accounting policy
(b) the reasons why applying the new policy provides more reliable and relevant information
(c) for the current and each prior period, to extent practicable, the amount of the adjustment:
for each financial statement line item effected; and
for basic and diluted EPS (only if the entity is applying IAS 33, *Earnings per Share*).
(d) For periods prior to those presented, the impact, if practicable
(e) If retrospective application is impracticable, the circumstances causing that condition and how change in policy has been applied.

When an entity has not applied a new IFRS or SIC that is published but not effective, the entity should disclose that fact and estimate the possible impact that its application will have on its financial statements.

Changes in Accounting Estimates

Many items in financial statements cannot be measured with precision but must be estimated. These involve judgements based on latest available information. Examples where this would be applied include bad debts, inventory obsolescence, useful lives, warranty obligations etc. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

The effect of a change in an accounting estimate shall be recognised prospectively by including it in profit or loss in:

the period of the change, if the change affects that period only; or
the period of the change and future periods, if the change affects both.

However, to the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it is recognised by adjusting the carrying amount of the related asset, liability, or equity item in the period of the change.

Disclosure Relating to Changes in Accounting Estimates

The nature and amount of a change in an 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.

Errors

Material prior period errors should be corrected retrospectively as soon as discovered by:
(a) restating the comparative amounts for the prior periods presented; or
(b) if the error occurred before the earliest period presented, by adjusting the opening balances of assets, liabilities and equity for the earliest period presented.

Limitations on Retrospective Restatement

An error should be corrected retrospectively unless impracticable. If that is the case the entity must restate the opening balances of assets, liabilities and equity for the earliest period for which retrospective restatement is practicable. If impracticable to determine the cumulative impact for all prior periods the entity shall restate the comparative information to correct the error prospectively from the earliest date practicable. The correction of prior period errors are not included in arriving at the profit or loss for the year.

Disclosures Relating to Prior Period Errors

The following should be disclosed:
(a) the nature of the prior period error
(b) for each prior period presented, to the extent practicable, the amount of the correction:
    for each financial statement line item affected and
    for basic and diluted EPS (only if the entity is applying IAS 33).
(c) The amount of the correction at the beginning of the earliest prior period presented
(d) 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.
These disclosures are only required in the year of discovery. Financial statements of subsequent periods need not repeat these disclosures.

Conclusion

The revised IAS 8 removes the option of the allowed alternative to retrospective application of voluntary changes in accounting policies and retrospective restatement to correct prior period errors and eliminates the concept of a fundamental error. It also clarifies the hierarchy of guidance to which management refers, whose applicability it considers when selecting accounting policies in the absence of Standards and Interpretations that specifically apply.

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