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Accounting policies, estimates and errors (LKAS 8)

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LKAS 8: Overview

- ❖ Objective
- ❖ Scope
- ❖ Definitions
- ❖ Accounting policies
- ❖ Impracticability in respect of retrospective application and retrospective restatement
- ❖ Changes in accounting estimates
- ❖ Errors
- ❖ Disclosures

LKAS 8: Objective

- ❖ **Prescribe the criteria for selecting and changing accounting policies, together with the accounting treatment and disclosure of**
  - ➢ Changes in accounting policies
  - ➢ Changes in accounting estimates
  - ➢ Corrections of errors

Definitions

- **Accounting policies**
  - ➢ Specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements

- **Change in accounting estimate**
  - ➢ An adjustment of the carrying amount of an asset or a 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

Definitions (Contd…)

- **Material**
  - ➢ Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements

- **Prior period error**
  - ➢ 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
    - Was available when financial statements for those periods were authorized for issue, and
    - Could reasonably be expected to have obtained and taken into account in the preparation and presentation of those financial statements

Definitions (Contd…)

- **Retrospective application**
  - Applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied
- **Retrospective restatement**
  - Correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred

Determining Accounting Policies

- **IFRS/SLFRS has fewer pronouncements than US GAAP**
  - Need guidance about how to develop policies where issues are not covered by standards or interpretations
- **LKAS 8 deals with selecting accounting policies; 'where an LKAS/SLFRS specifically applies to a transaction, other event or condition, the accounting policy or policies applied to that item shall be determined by applying the SLFRS'**

Determining Accounting Policies (Contd…)

- **If no SLFRS specifically applies**
  - ➢ Management shall use its judgement in developing and applying an accounting policy that results in information that is:
    - Relevant to economic decision-making needs of users, and
    - Reliable
  - ➢ Reliable if it represents faithfully financial performance and cash flows, reflects economic substance, is neutral, prudent and complete in all material respects
  - ➢ 'Principles-based'

Determining Accounting Policies (Contd…)

- **In making judgements when developing a policy in the absence of specific SLFRS, refer to following sources in descending order:**
  - ➢ Requirements of SLFRSs dealing with similar and related issues
  - ➢ Definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Framework
- **When developing a policy, may also consider the following 'to the extent that these do not conflict with other SLFRSs and the Framework'**
  - ➢ Most recent pronouncements of other standard-setting bodies that use similar conceptual framework - for example US GAAP
  - ➢ Other accounting literature and accepted industry practices

Changes in Accounting Policy

- **Changes in accounting policy should be made only if:**
  - ➢ Required by a Standard or an Interpretation, or
  - ➢ 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 flow

- **Retrospective application**
  - ➢ Initial application of a Standard or Interpretation that does not include transitional provisions
  - ➢ Voluntary changes in accounting policy

Changes in Accounting Policy (Contd…)

- **Retrospective adjustment**
  - ➢ Present as if the new accounting policy had always been applied:
    - Adjust opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period
  - ➢ If it is impracticable to quantify the change, the entity applies the new policy from the beginning of the earliest period for which retrospective application is practicable

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Impracticability

- **When the entity cannot apply the change after making every reasonable effort to do so**
- **Circumstances where this might be the case:**
  - ➢ Where the effects of retrospective application are not determinable (e.g., where the information is not available because it was not captured at the time)
  - ➢ If restatement requires assumptions about what would have been management's intent at the time
  - ➢ When restatement requires use of estimates and it is impossible to distinguish evidence of circumstance at the time of the transaction to be revised or whether they were available at the time

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Changes in Accounting Estimates

- **Prospective application**
  - ➢ Including it in profit or loss in
    - Period of the change, if the change affects that period only
    - Period of the change and future periods, if the change affects both
  - ➢ Adjust the carrying amount of an asset, liability or equity item in the period of change

Change in Accounting Policy or Estimate?

- A determines that it is more appropriate to charge depreciation on its mines using units of consumption rather than straight-line depreciation
- B decides that it will no longer state its investment properties at fair value but will instead use depreciated historic cost
- C reclassifies overheads formerly carried within cost of sales as administrative expenses
- D adopts a new statistical basis for measuring its warranty provisions

Errors

- **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:**
  - ➢ Was available when financial statements for those periods were authorised for issue, and
  - ➢ Could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements

- **Examples**
  - ➢ Mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud

Correction of Accounting Errors

- **Retrospectively**
  - In first set of financial statements authorised for issue after their discovery
  - Restate comparative amounts for prior periods presented in which the error occurred, or
  - If earlier period, restate opening balances of assets, liabilities and equity for the earliest prior period presented
- **Impracticable to restate**
  - Restate for earliest period that is practicable
  - Restate comparative information prospectively from earliest date practicable

Accounting Policies Disclosures

- **Management judgements in applying policies having most significant effect on the amounts recognised in the financial statements**
  - Other than those involving estimates below
- **Assumptions about the future, and other major sources of measurement uncertainty, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within next financial year**
  - Give details of the nature and carrying amounts at the end of the period

Accounting Policies Disclosures (Contd…)

- **Examples of management judgements**
  - ➢ 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 special purpose entity is controlled by the entity

Accounting Policies Disclosures (Contd…)

- **Assumptions about the future - disclose:**
  - ➢ Nature of the assumption or other estimation uncertainty
  - ➢ Sensitivity of carrying amounts to methods, assumptions and estimates underlying their calculation
  - ➢ Expected resolution of an uncertainty and the range of reasonably possible outcomes within the next year, and
  - ➢ Explanation of changes made to past assumptions if the uncertainty remains unresolved

Voluntary Change in Accounting Policy Disclosures

- **Nature of change**
- **Why new policy provides reliable and more relevant information**
- **For all periods presented, to the extent practicable, the amount of the adjustment**
  - For each financial statement line item affected, and
  - Impact on EPS if LKAS 33 applies to the entity

Voluntary Change in Accounting Policy Disclosures (Contd…)

- **Amount of the adjustment relating to periods before those presented, to the extent practicable, and**
- **If retrospective application is impracticable**
  - Why it is impracticable
  - How and from when the change has been applied

Voluntary Change in Accounting Policy Disclosures (Contd…)

- Title of standard or interpretation
- Change made in accounting policy in accordance with any transitional provisions
- Nature of the change in policy
- Description of any transitional provisions
- Any transitional provisions that might affect future periods

Mandatory Change in Policy Disclosures

- **For current and prior periods presented, if practicable, the amount of adjustment**
  - ➢ For each line item affected, and
  - ➢ For basic and diluted EPS
- **Amount of adjustment relating to prior periods not presented, if practicable**
- **If retrospective application is required but is impracticable, then:**
  - ➢ A description of the circumstances, and
  - ➢ How and from when the change in accounting policy has been applied

Changes in Estimates Disclosures

- **Nature and amount of a change in accounting estimate that:**
  - Has an effect in the current period, or
  - Is expected to have an effect in future periods (if practicable)

- **If the amount of the effect in future periods is not disclosed because it is impracticable, that fact should be disclosed**

Prior Period Errors Disclosures

- **Nature of the prior period error**

- **For each prior period presented (if practicable), the amount of correction**
  - For each line item affected, and
  - Basic and diluted EPS, if applicable

- **The amount of the correction at the beginning of the earliest prior period presented, and**

- **If retrospective restatement is impracticable for a particular period, the circumstances and description of how and from when the error has been corrected**

New SLFRS issued but not yet Applied: Disclosures

- **When an SLFRS has been issued but is not yet effective (and has not been applied), disclose**
  - This fact
  - Known or reasonably estimable information relevant to assessing the possible impact that applying the new SLFRS will have on the financial statements in the first period of initial application
    - Guidance re possible disclosures - e.g. title of SLFRS, nature of impending change in policy, date by which it must be applied, date on which it intends to apply it initially and either a discussion of the impact that is expected on initial application or a statement that this is not known or cannot be reasonably estimated

Illustration 1- Disclosure of Accounting Policy Change

In 20X2, the entity was required to comply with an amendment to the *SLFRSs*. The cumulative effect of the change in accounting policy on the retained earnings of the entity at the beginning of 20X1 is a CU80,000 decrease. The effect on profit before tax for 20X1 is a CU25,000 decrease, with a resultant decrease in income tax expense of CU5,000.

Extract from statement of income and retained earnings for the year ended 31 December 20X2

	Notes	*20X2*	*20X1*
			Restated
		CU	*CU*
Profit before tax (20X1: previously stated CU185,000)		200,000	160,000
Income tax expense (20X1: previously stated CU45,000)		(50,000)	(40,000)
Profit for the year (20X1: previously stated CU140,000)		150,000	120,000
Retained earnings at the beginning of the year		320,000	200,000
- as previously stated		420,000	280,000
- effect of the change in accounting policy	12	(100,000)	(80,000)
Retained earnings at the end of the year		470,000	320,000

Notes to the financial statements for the year ended 31 December 20X2

Note 12 Change in accounting policy

In 20X2 in accordance with an amendment to Section X … of the *SLFRSs* the entity changed its accounting policy for …. Previously, the entity had …….. The entity now …….. This change in accounting policy has been accounted for retrospectively, and the comparative information for 20X1 has been restated. The effect of the change is a reduction of CU20,000 in profit for the year ended 31 December 20X1. Furthermore, opening retained earnings for 20X1 have been reduced by CU80,000, which is the amount of the adjustment relating to periods before 20X1.

(Note: The effect of the restatement on the statement of financial position (and other statements) must also be presented).

Illustration 2 – Disclosure of Accounting Estimate Change

- An entity acquired a yacht for CU1,000,000 on 1 January 20X1 and appropriately assessed its useful life at 30 years from the date of acquisition with a residual value of CU100,000. The entity decided that the straight-line method is the most appropriate method on which to depreciate the yacht.

  In 20X9, the entity undertook substantial Study into the yachting industry. As a result, as at 31 December 20X9 the entity assessed the useful life of the yacht at 20 years from the date of acquisition with a residual value of CU500,000. It also assessed a fair value for the yacht as at 31 December 20X9 at CU800,000.

  It continued to believe that the straight-line method the most appropriate method of depreciation for the yacht

- Notes to the financial statements for the year ended 31 December 20X9

- Note 3 Operating profit

  Change in accounting estimate

  At 31 December 20X9, as a result of the Study undertaken about the yachting industry, the entity reassessed the useful life of its yacht at 20 years (previously 30 years) from the date of acquisition; and the residual value of its yacht at CU500,000 (previously CU100,000).This had the effect of decreasing the depreciation expense for the year ended 31 December 20X9 by CU8,333 (previously CU30,000 per year, now CU21,667 per year).Depreciation for each of the next 11 years is expected to be similarly affected by these changes in accounting estimates.

  Note: In this example, tax effects have been ignored

Illustration 3 – Disclosure of Accounting Error

- In 20X2, after the entity's 20X1 financial statements were approved for issue, the entity discovered a longstanding computational error in the calculation of depreciation expense. The cumulative effect of the error on the retained earnings of the entity at the beginning of the 20X1 is a CU80,000 overstatement. The error resulted in profit before tax for the year ended 31 December 20X1 being overstated by CU25,000, with a resultant CU5,000 overstatement of income tax expense.

Extract from statement of income and retained earnings for the year ended 31 December 20X2

	Notes	*20X2*	*20X1*
			Restated
		CU	*CU*
Profit before tax (20X1: previously stated CU185,000)		200,000	160,000
Income tax expense (20X1: previously stated CU45,000)		(50,000)	(40,000)
Profit for the year (20X1: previously stated CU140,000)		150,000	120,000
Retained earnings at the beginning of the year		320,000	200,000
- as previously stated		420,000	280,000
- effect of the correction of a prior period error	12	(100,000)	(80,000)
Retained earnings at the end of the year		470,000	320,000

- Notes to the financial statements for the year ended 31 December 20X2

  Note 12 Correction of prior period error

  In 20X2, the entity corrected mathematical mistakes that had resulted in the understatement of depreciation expense over the past [four] years. The correction of the error is accounted for retrospectively, and the comparative information for 20X1 has been restated. The effect of the change is a CU20,000 reduction in profit for the year ended 31 December 20X1. Furthermore, opening retained earnings for 20X1 have been reduced by CU80,000, which is the amount of the error relating to periods before 20X1.

- Note: The effect of the restatement on the statement of financial position (and other statements) must also be presented.

Illustration 4 – Selecting an accounting Policy

- The management of a recently incorporated entity, **Tronix Technology Plc** was in the process of deciding on the method of valuation for their inventory. However, they were not sure what the process involved.

  Mr. Edgebaston, the financial director of the entity, suggested that they look at IAS 2: Inventory, in order to obtain some guidance on the issue. After reading IAS 2, he brought the following to the attention of the other directors:

  IAS 2 prescribes the following methods for valuation of inventory:

  01. first-in-first-out (FIFO)
  02. weighted average

Illustration 4 – Answer

- An entity should use the same cost formula for all inventories having similar nature and use to the entity.

- For inventories with different nature or use (for example, certain commodities used in one business segment and the same type of commodities used in another business segment), different cost formulas may be justified.

- A difference in geographical location of inventories (and in the respective tax rules), by itself, is not sufficient to justify the use of different cost formulas

- Decision Process

  01. If no IFRS exists then the procedure would be to ensure that any accounting policy used was both **relevant** and **reliable**.

      In Mr. Edgebaston's situation *IAS 2* applies and as a result the requirements of the standard need to be followed

  02. Mr. Edgebaston located an IFRS (*IAS 2*) that he deems as suitable for **Tronix Technology Plc**'s needs. However, he should also look at:

      - any relevant IFRSs

      - appendices to the IFRS that do not form part of the IFRS, and

      - implementation guidance issued in respect of the IFRS

03. Now that all procedures have been followed, what should Mr Edgebaston do with the IFRS information he has found?

    - IAS 2: select either FIFO or the Weighted average

    - IAS 2: whichever method is selected must be applied consistently for inventories with similar nature and use

    - check that there is no other guidance available

04. Mr. Edgebaston decided that the FIFO method of valuation would best reflect the value of inventory on hand at year-end.

    He also realises that inventory with specific nature and use should have the same accounting policy and should be consistently applied

Illustration 5 - Changing a Policy - What to Consider

Prop-Rent Plc is an entity that buys apartments in Colombo and then leases them out to individuals. The entity's financial manager, Mr. X, heard about the implementation of *LKAS 40: Investment Property*.

Mr. X read that, according to *IAS 40*, the entity has the option to value its investment property at either **fair value**, or by using the **cost model**.

In the past the entity has valued its investment property at cost, less accumulated depreciation and accumulated impairment losses.

MR. X considered changing the measurement model to the fair value model.

Illustration 5 – Answer

1. *The change is as per an LKAS*
   LKAS 40 gives the entity the option to select the fair value model of measurement.

   Therefore the entity may value its investment property in terms of the fair value model

2. *If change results in a) more relevant presentation of financial statements or b)more reliable presentation of financial statements* it is a voluntary change in accounting policy.

- Conclusion
  The change is permitted by *LAS 40*, and as a result should be accounted for and disclosed as specified in *LKAS 8 as a voluntary change. So retrospective application is required. However impracticability may prompt the company to effect changes in a prospective manner.*

Illustration 6 - Changes to an accounting Estimate

- Jonathan Hardson is the financial manager of an entity called Powerflux Ltd, a household electronics manufacturer and retailer.

  Due to a change in the business environment, Mr Hardson needed to make some changes to the way the company offers warranties to their customers

- **Situation**
  The entity Powerflux Ltd was in process of changing its provision for sales warranties. In the past the entity had created a provision at 5% of total sales for the year.

  Due to the increase in sales returns over the past 3 years, the entity changed the percentage applied to sales warranties to 8.5%.

  The financial manager, Mr Jonathan Hardson read that there are different accounting and disclosure requirements for a change in accounting estimates and a change in accounting policy. As a result he was keen to determine whether the change in the warranty policy will be a change in estimate or in policy.

Illustration 6 – Answer

- **Change in Estimate**
  Certain financial statement items cannot be measured with certainty - but are estimates. Therefore it would seem that this would apply to the changes that Mr. Hardson would have liked to make.

Conclusion
The change in the percentage governing the sales warranty provision is a change in accounting estimates, and as a result should be accounted for and disclosed in terms of the rules in *LKAS 8* that governs a change in accounting estimates.

Illustration - 7 Error

Upon investigation Heather discovered that the entity had not depreciated its water rafting equipment since purchase 3 years ago (2012).

Should this have been classified as an error, and if so what would the accounting requirements be in terms of *LKAS 8?* Let's investigate.

Note: The entity presents current year (2015) and the prior year (2014) on the financial statements.

Illustration 7 – Answer

- Taking the definition into account, it is apparent that the incident with **Adventure Tech** should have qualified as an **error**.
- The error should be accounted for retrospectively, by either:
- restating comparative amounts for the prior period(s) in which the error occurred, **or**
- if the error occurred before the earliest prior period presented, restating the opening balance of retained earnings for the earliest prior period presented
- This ensures the financial statements are presented as if the error had never occurred
- Due to the fact that the error occurred before the earliest period presented (the error occurred in 2012, which is before the earliest period presented – 2013), the opening balance of retained earnings for the earliest period presented (2013) should be restated.