STAFF PAPER

REG IASB Meeting

Project	**Review of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors***
Paper topic	Distinction between changes in accounting policies and changes in accounting estimates: changes to wording

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Purpose of the paper

1. As explained in Agenda paper 26, staff received some feedback on the wording of the amendments during the Board meeting in April 2016 and during the ASAF meeting in July 2016. This paper recommends some changes to that wording.

2. The rest of this paper discusses changes in respect of:

   (a) removal of the threshold for changes in estimation techniques and valuation techniques (ie removing the proposed added requirement that the resulting measurement should be equally or more representative of the amount being estimated)—paragraphs 4-8

   (b) the definition of accounting policies—paragraphs 9-19

   (c) changes in cost formulas for interchangeable inventories (ie FIFO and Weighted Average Cost)—paragraphs 20-24.

3. The paper also has appendices:

   (a) Appendix A—comparing the wording recommended in this paper to the current wording in IAS 8

   (b) Appendix B—quoting paragraphs 65 and 66 of IFRS 13 *Fair Value Measurement*.

Current recommendations

Threshold for changes in estimation and valuation techniques

4. In April 2016 we recommended adding to the main body of IAS 8 (as a new paragraph 34A) some further guidance about changes in estimation techniques and valuation techniques. The guidance recommended then would:

    (a) clarify that changes in estimation techniques and valuation techniques are changes in accounting estimates because estimation uncertainty exists in selecting estimation techniques and valuation techniques; and

    (b) add a threshold for changes in estimation techniques and valuation techniques (ie the resulting measurement should be equally or more representative of the amount being estimated).

5. In April 2006, the wording we recommended for paragraph 34A concerning the threshold for changes in estimation techniques and valuation techniques was largely aligned with the existing guidance in paragraphs 65 and 66 of IFRS 13 (please see Appendix B).

6. During discussions with the Board, and especially with ASAF members, we heard the following feedback about introducing the threshold for changes in estimation techniques and valuation techniques:

    (a) IAS 8 already says that estimates should be reasonable and they should be based on the latest available, reliable information;

    (b) introducing the threshold would impose unjustifiable burdens and costs on preparers of financial statements because:

        (i) the test would require a substantial amount of effort; and

        (ii) changes in estimation techniques and valuation techniques are common;

(c) introducing thresholds might be perceived as intending to change the existing guidance in IAS 8, which was not the intention of this project; and

(d) from the standard-setting point of view, the most effective way to handle this issue might be to set thresholds when required in individual standards as, for example, IFRS 13 does.

7. After having considered the feedback above, we now do not recommend introducing any such thresholds for changes in estimation techniques and valuation techniques in IAS 8.

8. The mark-up below shows the changes we now recommend from the wording we recommended in April 2016. The full mark-up from IAS 8 to the currently recommended wording is provided in Appendix A.

34A If an entity uses estimation techniques or valuation techniques in making accounting estimates, a change from one technique to another is a change in an accounting estimate. ~~A change in an estimation technique or in a valuation technique is appropriate if, in the circumstances, the resulting measurement is equally or more representative of the amount being estimated. This may be the case if, for example, any of the following events take place:~~

~~(a) new markets develop;~~

~~(b) new information becomes available;~~

~~(c) information previously used is no longer available;~~

~~(d) estimation techniques or valuation techniques improve; or~~

~~(e) market conditions change.~~

Question 1
Staff previously recommended adding a threshold for changes in estimation techniques and valuation techniques (ie the resulting measurement should be equally or more representative of the amount being estimated). After further feedback and consideration, staff now recommend removing this threshold. Do you agree with the removal from the new paragraph 34A of the previously recommended threshold for changes in estimation techniques and valuation techniques?

Definition of 'accounting policies'

9. The wording of the definition of accounting policies that staff recommended to the Board in April 2016 differed from IAS 8 in the following respects:

   (a) We removed the terms 'bases', 'conventions' and 'rules' because the meaning of these terms is not clear and they are not used in IFRSs.

   (b) We also removed 'other practices' for the same reason. In addition, staff thought that the term might be misunderstood as covering estimation techniques and valuation techniques that entities use in making their estimates.

   The objective of the recommended amendments was to make the definition more concise and distinctive. As a result of the recommended amendments the amended definition of accounting policies was as follows:

Clean text
Accounting policies are the specific principles applied by an entity in preparing and presenting financial statements.

10. During discussions with the Board and ASAF members, Board members and some ASAF members expressed overall support for the shortened definition. Nevertheless, some Board members and ASAF members believed that referring in the definition

only to ‘principles’ would perhaps lead some people to interpret the definition too narrowly.

11. Staff considered this feedback and looked at the recommended definition of accounting policies once again. There are two views on the best way to approach the definition of accounting policies:

    (a) *Approach 1*: keep the shortened definition of accounting policies proposed in April 2016 and add ‘practices’; and

    (b) *Approach 2*: keep the existing definition of accounting policies in IAS 8, ie add back 'bases', 'conventions', 'rules' and ‘other practices’.

Approach 1

12. Supporters of this view look at the amended definitions of accounting policies and a change in accounting estimate in combination. They believe that the shortened definition of accounting policies—in combination with the improved definition of a change in accounting estimate—conveys a clearer and more concise message about how accounting policies and accounting estimates relate to each other. As mentioned earlier, there has been general support for the amended definitions of accounting policies and of a change in accounting estimate during the formal and informal outreach performed so far.

13. In addition, supporters of this view continue to believe that the meaning of the terms 'bases', 'conventions', 'rules' in the context of the definition of accounting policies is not clear (especially to non-native English speakers) and that using these terms may lead some people to interpret the definition of accounting policies in IAS 8 too broadly.

14. Staff acknowledge that the remaining terms ‘principles’ and ‘practices’ are not clearly defined in IFRSs either, although the term ‘principles’ is generally well understood. Nevertheless, in summary and on balance, supporters of this view believe that the shortened definition of accounting policies better meets the objective of this project to clarify the distinction between changes in accounting policies and accounting

estimates. Consequently, they do not recommend reintroducing 'bases', 'conventions' and 'rules' in the definition of accounting policies.

15. Supporters of this view further believe that the definition of accounting policies should refer to ‘specific principles and <u>practices</u>’ because:

    (a) of the concern explained in the previous paragraphs, ie referring to principles only is too limiting;

    (b) some people think that the term ‘practices’ would clarify that accounting policies include those that are developed in the absence of specific IFRS guidance that would apply to a transaction (see paragraphs 10-12 of IAS 8); and

    (c) new paragraph 34A provides guidance about estimation techniques and valuation techniques. This would eliminate the potential misunderstanding mentioned in paragraph 9(b), namely that ‘practices’ might be misunderstood as covering estimation techniques and valuation techniques.

16. The amended definitions in paragraph 5 of IAS 8 would now read as follows. The mark-up is from the wording we recommended in April 2016 in the previous Board paper to this paper. The full mark-up from IAS 8 to the currently recommended wording is provided in Appendix A.

> *Accounting policies* are the specific principles <u>and practices</u> applied by an entity in preparing and presenting financial statements.
>
> *A change in accounting estimate* is an adjustment of the carrying amount of an asset or a liability, resulting from new information (or some other new development) that causes a change in judgements or assumptions used in applying the accounting policy for that asset or liability.

Approach 2

17. Those who believe that the definition of accounting policies should remain unchanged from the definition currently in IAS 8 believe so for the following reasons:

    (a) the improvements to the definition of a change in accounting estimate provide sufficient additional clarity, and as much clarity as is achievable;

    (b) taking the terms out of the definition does not address any known problem in practice and might have unintended consequences. In discussions on deleting terms included in the current definition, different people have drawn different conclusions about the meaning of each term—and hence about the consequences of deleting it. Thus, deleting any of the terms would lead to uncertainty without providing any clearly demonstrated benefit.

18. The existing definition of accounting policies in paragraph 5 of IAS 8 is as follows:

> *Accounting policies* are the specific principles, bases, conventions, rules and other practices applied by an entity in preparing and presenting financial statements.

Staff recommendation

19. After having considered merits of both approaches, staff recommend adopting Approach 1 to the amendments to the definition of accounting policies in IAS 8. This is because staff think that adopting this approach will result in:

    (a) a more concise and distinctive definition of accounting policies; and

    (b) a clearer and more concise message about how accounting policies and accounting estimates relate to each other.

Question 2
Do you agree with the definition of accounting policies recommended in paragraph 16?

Change in cost formulas for interchangeable inventories

20. Throughout this project people have asked whether a change in the cost formulas that are used for determining the cost of interchangeable inventories (ie FIFO and Weighted Average Cost) in IAS 2 *Inventories* is a change in an accounting policy or a change in an accounting estimate.

21. The recommended amendments aim to explain that accounting estimates are a means of applying accounting policies when estimates have to be made. However, in our view, that clarification is not, by itself, sufficient to enable people to answer this specific issue. This is because the answer to this issue depends too much on specifics of this issue.

22. As we noted in the Agenda paper presented to the Board in April 2016, the need to select FIFO or Weighted Average Cost arises only for inventories that are ordinarily interchangeable as described in paragraphs 25-27 of IAS 2. The order in which those items flow through a cycle of transactions has no economic consequences. (If the order has economic consequences, the items are not interchangeable.) Thus, selecting one of the two cost formulas is simply an arbitrary decision and does not involve an attempt to estimate the actual order of flow of inventory items. It follows that there is no estimation uncertainty to address and selecting a particular cost formula is the selection of an accounting policy.

23. The Basis for Conclusions of IAS 2 explains why the LIFO method (prohibited by IAS 2 since revisions to IAS 2 in 2003) is clearly unsuitable for measuring cost of interchangeable inventories. However, the Basis for Conclusions does not deal with the question of changes between the two cost formulas that are still allowed.

24. We are not convinced that entities often change from one cost formula to the other. Nevertheless, we have been asked about this issue repeatedly. For this reason, we recommend adding the following paragraph in the section **Changes in accounting policies** of IAS 8:

18A When there is a change in the cost formula selected in accordance with paragraphs 25-27 of IAS 2 *Inventories* in determining the cost of interchangeable inventories, that change is a change in an accounting policy.

Question 3

Do you agree with the staff recommendation to add to IAS 8 the explicit statement made in paragraph 24?

Appendix A

Comparison of the recommended wording in this paper to the current wording in IAS 8

A1. The amended text of the definitions in paragraph 5 of IAS 8 would now read as follows (mark-up is from IAS 8). As shown in paragraph 16, there has been one change since the previous Board paper: in the definition of accounting policies.

Definitions

> *Accounting policies* are the specific principles~~, bases, conventions, rules~~ and ~~other~~ practices applied by an entity in preparing and presenting financial statements.
>
> *A change in accounting estimate* is 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. Changes in accounting estimates~~ resulting from new information (or some other new development~~s~~)~~,~~ that causes a change in judgements or assumptions used in applying the accounting policy for that asset or liability ~~and, accordingly, are not corrections of errors~~.

A2. The new paragraph 18A of IAS 8 would now read as follows (mark-up is from IAS 8). This paragraph has been added since the previous Board paper.

Change in accounting policies

18A When there is a change in the cost formula selected in accordance with paragraphs 25-27 of IAS 2 *Inventories* in determining the cost of interchangeable inventories, that change is a change in an accounting policy.

A3. The amended text in paragraphs 32-35 of IAS 8 would now read as follows (mark-up is from IAS 8). There have been no changes since the previous Board paper.

Changes in accounting estimates

32 As a result of the uncertainties inherent in business activities, many items in financial statements cannot be measured with precision ~~but can only be estimated~~. Thus, entities may need to use accounting estimates in applying their accounting policies for some of those items. Estimation involves making judgements or assumptions based on the latest available, reliable information. For example, estimates may be required of:

(a) bad debts;

(b) inventory obsolescence;

(c) the fair value of ~~financial~~ assets or ~~financial~~ liabilities, if not determined by using a quoted price (unadjusted) in an active market for identical assets or liabilities;

(d) the useful lives of, or expected pattern of consumption of the future economic benefits embodied in depreciable assets; and

(e) warranty obligations.

33 The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

34 An estimate may need revisions if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience. By its nature, the revision of an estimate does not relate to prior periods and is not a correction of an error.

A4. The new paragraph 34A of IAS 8 would now read as follows (mark-up is from IAS 8). There have been two changes since the previous Board paper:

(a) the threshold for a change has been removed; and

(b) an explicit explanation about why a change in an estimation or a valuation technique is considered to be a change in an accounting estimate has been added.

<u>34A</u> <u>If an entity uses estimation techniques or valuation techniques in making accounting estimates, a change in those techniques is a change in an accounting estimate.</u>

35 A change in the measurement basis applied is a change in an accounting policy, and it is not a change in an accounting estimate. When it is difficult to distinguish a change in an accounting policy from a change in an accounting estimate, the change is treated as a change in an accounting estimate.

Appendix B

Paragraphs 65-66 of IFRS 13

address valuation techniques and changes in valuation techniques.

65 Valuation techniques used to measure fair value shall be applied consistently. However, a change in a valuation technique or its application (eg a change in its weighting when multiple valuation techniques are used or a change in an adjustment applied to a valuation technique) is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. This may be the case if, for example, any of the following events take place:

(a) new markets develop;

(b) new information becomes available;

(c) information previously used is no longer available;

(d) valuation techniques improve; or

(e) market conditions change.

66 Revisions resulting from a change in the valuation technique or its application shall be accounted for as a change in accounting estimate in accordance with IAS 8. However, the disclosures in IAS 8 for a change in accounting estimate are not required for revisions resulting from a change in a valuation technique or its application.