VIRTUAL COACHING CLASSES ORGANISED BY BOS, ICAI

CA FINAL

TOPIC : IND AS 8 – ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

PAPER : FINANCIAL REPORTING (FR)

Faculty: CA Amit Jain

Accounting Policies, Changes in Accounting Estimates and Errors

Scope of Ind AS 8

- Accounting Policies
- Changes in Accounting Estimates
- Errors

Accounting Policies

What are Accounting policies ?

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

- **Few examples of accounting policies are:**
  - **Basis of accounting –** Cash or accrual or hybrid?
  - **Method of determination of cost of inventories –** FIFO or specific identification or Weighted Average?
  - **When should revenue be recognised?**

- An entity shall select and apply its accounting policies **consistently** for similar transactions, other events and conditions.

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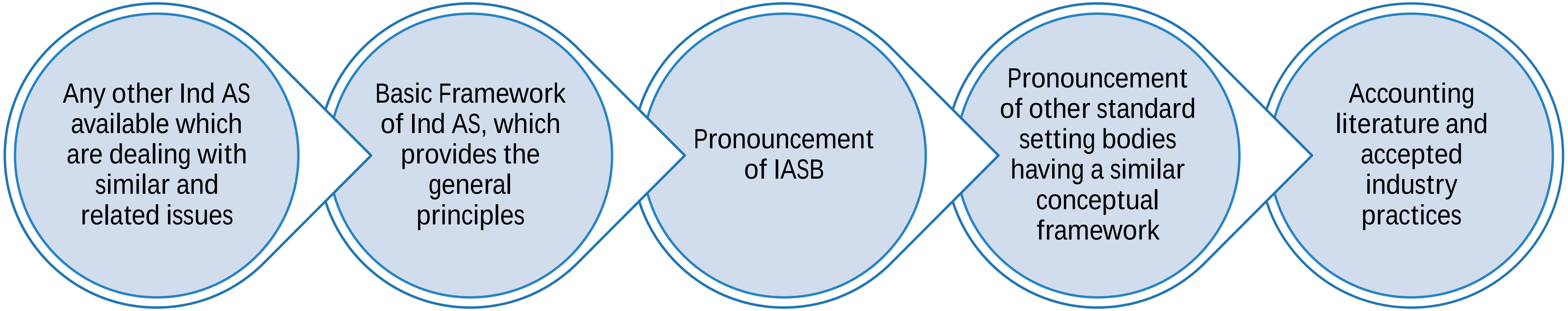
Selection and application of accounting policies

- **Applicable Accounting Standards**
  - Entity must **follow that standard** and apply the accounting policy as per the guidance provided in Ind AS.

- **Guidance note issued by ICAI**
  - An entity can also refer to guidance notes which are published by ICAI, along with the relevant Ind AS if **there is an ambiguity or there is need to go into the depth of a particular transaction.**

Selection and application of accounting policies (cont'd.)

- **In the absence of an Ind AS that specifically applies to a transaction:**
  - Management shall **use its judgement** in developing and applying an accounting policy. Accounting policy should be **'Relevant' and 'Reliable'.**
  - **Ind AS 8 requires that in absence of specific Ind AS, the entity should refer to the following material, in their descending order:**



Changes in accounting policies

<u>Change in accounting policies</u>

a) **Required by an Ind AS**

b) Results in financial statements **providing reliable and more relevant information**

<u>Not treated as change in accounting policies</u>

a) Application of accounting policies for transactions that **<u>differ in substance from those previously occurring</u>**

b) Application of new accounting policies for new transactions

The **<u>frequent changes</u>** in accounting policies are **not permitted** by Ind AS 8 since this will make it impossible for a stakeholder to make the economic decisions properly

Case Study

- Whether change in functional currency of an entity represents a change in accounting policy?

- Application of an accounting policy that differs in substance from those previously occurring are not changes in accounting policies.
- Moreover, Ind AS 21 notes that an entity's functional currency reflects the underlying transactions, events and conditions that are relevant to it.
- Accordingly, once determined, the functional currency is not changed unless there is a change in those underlying transactions, events and conditions. Thus, functional currency of an entity is not a matter of an accounting policy choice and Ind AS 8, therefore, does not apply to such a change.

Case Study

- Entity ABC acquired a building for its administrative purposes and presented the same as property, plant and equipment (PPE) in the financial year 20X1- X2.
- During the financial year 20X2- X3, it relocated the office to a new building and leased the said building to a third party.
- Following the change in the usage of the building, Entity ABC reclassified it from PPE to investment property in the financial year 20X2- X3.
- Should Entity ABC account for the change as a change in accounting policy?

- Whether a building is an item of property, plant and equipment (PPE) or an investment property for an entity depends on the purpose for which it is held by the entity.
- It is thus possible that due to a change in the purpose for which it is held, a building that was previously classified as an item of property, plant and equipment may warrant reclassification as an investment property, or vice versa.
- Thus, the classification of a building as an item of property, plant and equipment or as an investment property is not considered as change in accounting policy.

Applying the changes in accounting policies

Scenarios of changes in accounting policy *(dealt by Ind AS 8)*

Changes due to initial application of Ind AS		Changes are voluntarily
Where there is *specific transitional provisions in Ind AS Standards*	**Where there is no *specific transitional provisions in Ind AS Standards***	
Entity needs to **follow** the transitional provisions accordingly Eg. Ind AS 115, 116 etc.	Entity needs to apply changes **retrospectively**	Entity needs to apply changes **retrospectively** Eg. Change in inventory valuation method

Case Study

- Whether an entity can change its accounting policy of subsequent measurement of property, plant and equipment (PPE) from revaluation model to cost model?

- As per Ind AS 16, an entity shall choose either the cost model or the revaluation model as its accounting policy for subsequent measurement of an entire class of PPE.
- Such change, if it results in the financial statements providing reliable and more relevant information to the users of financial statements, is considered permissible in accordance with Ind AS 8.
- Accordingly, it shall be accounted for retrospectively.

Other Points

- Early application of an Ind AS is not a voluntary change in accounting policy

Retrospective application

- When a change in accounting policy **is applied retrospectively**, the entity shall adjust the **opening balance of each affected component of equity for the earliest prior period presented** and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied.

Disclosures

A. When initial application of an Ind AS has an effect on the current period or any prior period an entity shall disclose:

(a) Tittle of the Ind AS;

(b) When applicable, that the change in accounting policy is made in accordance with its transitional provisions;

(c) Nature of the change in accounting policy;

(d) Description of the transitional provisions;

(e) Transitional provisions that might have an effect on future periods;

(f) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:

(i) for each financial statement line item affected; and

(ii) if Ind AS 33, ‘Earnings per Share’, applies to the entity, for basic and diluted earnings per share;

(g) Amount of the adjustment relating to periods before those presented, to the extent practicable; and

(h) If **retrospective application is impracticable** for a particular prior period, or for periods before those presented, the circumstances that led to the **existence of that condition** and a description of how and from when the change in accounting policy has been applied.

Disclosures

B. When a voluntary change in accounting policy has an effect on the current period or any prior period an entity shall disclose:

(a) Nature of the change in accounting policy;

(b) Reasons why applying the new accounting policy provides reliable and more relevant information;

(c) For current period and each prior period presented, to the extent practicable, the amount of the adjustment:

(i) for each financial statement line item affected; and

(ii) if Ind AS 33 applies to the entity, for basic and diluted earnings per share;

(d) Amount of adjustment relating to periods before those presented, to the extent practicable; and

(e) If **retrospective application is impracticable** for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

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Disclosures

C. Ind AS issued but not yet effective :

When an entity has not applied a new Ind AS that has been issued but is not yet effective, the entity shall disclose:

(a) Fact; and

(b) Reasonably **estimable** information relevant to assessing the **possible impact that application** of the new Ind AS will have on the entity's financial statements in the period of initial application.

Other Disclosures :

(a) Title of the new Ind AS;

(b) Nature of the impending change or changes in accounting policy;

(c) Date by which application of the Ind AS is required;

(d) Date as at which it plans to apply the Ind AS initially;

(e) Either:

(i) a discussion of the impact that initial application of the Ind AS is expected to have on the entity's financial statements; or

(ii) if that impact is not known or reasonably estimable, a statement to that effect.

Accounting Estimates

2.1 Accounting estimates

- Many items in financial statements cannot be measured with precision but can only be estimated, due to the uncertainties inherent in business activities.
- Estimation involves <u>judgements based on the latest available, reliable information</u>.
- **For example, estimates may be required of:**
  - Provision for doubtful debts
  - Provision for Inventory obsolescence
  - Fair value of financial assets or financial liabilities
  - Useful lives of, or expected pattern of consumption of the future economic benefits embodied in, depreciable assets
  - Warranty obligations.
  - Recoverability of deferred Taxes.

2.2 Changes in accounting estimates

Accounting treatment

- The effect of change in an accounting estimate, except to the extent that the change results in change in assets, liabilities or equity, shall be **recognised prospectively by including it in profit or loss in:**
  - a) the period of the change, if the change affects that period only; or
  - b) the period of the change and future periods, if the change affects both.

- The effect of change in an accounting estimate gives rise to changes in assets, liabilities, or equity shall be recognised by adjusting the carrying amount of the related asset, liability or equity item in the period of the change.

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Can changes in estimates be related to prior periods?

- Changes in accounting estimates do not relate to prior periods, since an estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience.

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Changes in **basis of measurement**

Change in the basis of measurement – Whether a change in accounting policy or change in estimate?

- A change in the measurement basis applied is a change in an accounting policy, and 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.**

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Case Study

- Whether a change in inventory cost formula is a change in accounting policy or a change in accounting estimate?

- Ind AS 2, ‘Inventories’, specifically requires disclosure of ‘cost formula used’ as a part of disclosure of accounting policies adopted in measurement of inventories.

- Therefore, a change in cost formula is a change in accounting policy.

2.3 Changes in accounting estimates – Disclosures

Disclosure

- Effect of change in estimate on the current period
- If applicable and practicable, effect of **change in estimate on the future periods**
- If applicable but impracticable, the fact that it is impracticable to estimate the effect on future periods.

Prior Period Errors

Prior period errors

- **Prior period errors** are **omissions from, and misstatements** in, the entity's financial statements for **<u>one or more prior periods</u>** arising from a failure to use, or misuse of, reliable information that:

  a) Was available when financial statements for those periods were approved 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.

Prior period errors – Common types

Common types of errors

Mathematical Mistakes	Mistakes in applying policies	Misinterpretations of facts	Omissions	Frauds
▶ These errors are called as error of commission. ▶ Wrong calculations, carry forward of wrong balances and errors in totals are few examples of mathematical errors	▶ It comprises deviations from the methods of applying specific accounting policies, prescribed under specific standards.	▶ It comprises errors relating to managements judgement.	▶ It comprises errors that happened due to omission to record a material transaction.	▶ It comprises major theft undetected in past.

Prior period errors – Accounting treatment

- **Treatment of errors**
  - Prior period errors discovered subsequently
    - Situation 1: Error discovered relates to the comparative prior period presented
      - Correct the errors **retrospectively** by restating the comparative amounts for the prior period(s) presented in which the error occurred
    - Situation 2: Error discovered relates to period before the earliest comparative prior period presented
      - Correct the errors **retrospectively** by restating the opening balances of assets, liabilities and equity for the earliest prior period presented.
  - Potential Errors of Current Period

Case Study

An entity has presented certain material liabilities as non-current in its financial statements for periods upto 31st March, 20X1.

While preparing annual financial statements for the year ended 31st March, 20X2, management discovers that these liabilities should have been classified as current. The management intends to restate the comparative amounts for the prior period presented (i.e., as at 31st March, 20X1).
Would this reclassification of liabilities from non-current to current in the comparative amounts be considered to be correction of an error under Ind AS 8?

Would the entity need to present a third balance sheet?

- Reclassification of liabilities from non-current to current would be considered as correction of an error under Ind AS 8. Accordingly, in the financial statements for the year ended 31st March, 20X2, the comparative amounts as at 31st March, 20X1 would be restated to reflect the correct classification.

- Accordingly, the entity should present a third balance sheet as at the beginning of the preceding period, i.e., as at 1st April, 20X0 in addition to the comparatives for the financial year 20X0-X1.

Prior period errors – Disclosures

An entity shall disclose the following:

(a) Nature of the prior period error;

(b) For each prior period presented, to the extent practicable, the amount of the correction:

i. for each financial statement line item affected; and

ii. if Ind AS 33 applies to the entity, for **basic and diluted earnings per share;**

(c) Amount of the correction at the beginning of the earliest prior period presented; and

(d) If retrospective restatement is **impracticable for a particular prior period**, the circumstances that led to the existence of that condition and a description of how and from when the error has been corrected.

Financial statements of subsequent periods need not repeat these disclosures.

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Thank you