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IAS® Standard 8 Accounting Policies, Changes in Accounting Estimates and Errors

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IAS® Standard 8 Accounting Policies, Changes in Accounting Estimates and Errors

SCOPE AND KEY DEFINITIONS

IAS Standard 8 Accounting Policies, Changes in Accounting Estimates and Errors shall be applied when selecting and applying accounting policies and accounting for changes in accounting policies, changes in accounting estimates, and corrections of prior period errors.

Table 1. Key definitions in IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

Term	Definition
Accounting policies	Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity when preparing and presenting financial statements.
A change in accounting estimate	A change in accounting estimate is an adjustment to the carrying amount of an asset or liability, or the amount of the periodic depreciation 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 result from new information or new developments and, accordingly, are not corrections of errors.
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 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. Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

RECOGNITION AND MEASUREMENT

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**. Estimation involves judgments based on the latest available and reliable information.

The accounting profession has identified two main categories for ***accounting changes***:

- Change in the accounting estimate

- Change in the accounting policy

The basic accounting issue is whether accounting changes should be reported as adjustments to the prior periods' statements or whether the changes should affect only current and future years.

Contrary to what many people believe, accounting information cannot always be measured precisely.

To be reported on a timely basis for decision making, accounting information often must be based on estimates of future events.

These estimates are based on the best professional judgement given the information available at the time and may have to be revised at a later time.

Some changes in accounting policies are actually just another form of a change in estimate.

If a company changes its depreciation method, it is actually making a statement about a change in the expected usage pattern with respect to that asset.

A change in depreciation method is accounted for as a change in estimate and is called "a change in accounting estimate affected by a change in accounting policy."

Accounting changes detract from the informational characteristics of comparability and consistency.

Comparability enables users to relate accounting information to a benchmark or standard. The benchmark may be in the form of another firm's financial statements or financial data from the same firm but for some other time period. An accounting change may make comparing data from one period to another or from one firm to another difficult, thus detracting from comparability. For example, if a company switched from the straight-line depreciation method to the double-declining balance depreciation method in 2015, depreciation expenses for 2015 are not comparable to prior years' depreciation expenses without knowing the effects of the change when accounting for depreciation.

Consistency means that a company applies the same methods to similar transactions and events from one period to another. Therefore, accounting changes, especially changes in methods used, would detract from the informational characteristic of consistency.

The use of reasonable estimates is an essential part of preparing financial statements and does not undermine their reliability. An estimate may need revision if changes occur in the circumstances upon 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 the correction of an error. A change in the applied measurement basis is a change in an accounting policy and not a change in an accounting estimate.

Prospective recognition of the effect of a change in an accounting estimate means that the change is applied to transactions, other events, and conditions starting from the date of the change in estimate. A change in an accounting estimate may affect only the current period's profit or loss, or the profit or loss of both the current and future periods.

Examples of areas for which changes in accounting estimates are often made include the following:

(1) Uncollectible receivables
(2) Useful lives of depreciable assets
(3) Residual values for depreciable assets
(4) Warranty obligations
(5) Amounts of mineral reserves to be depleted
(6) Actuarial assumptions for pensions or other postemployment benefits
(7) Number of periods benefited by deferred costs

A change in estimate should be reflected either in the current period or in current and future periods. No retrospective adjustments are to be prepared for a change in the accounting estimate.

Example 1
Change in Accounting Estimate

On January 1, 2019, company X bought a fixed asset with a cost of CU 100,000 and a useful life of 20 years. Also, its salvage value was CU 2,000. In 2022, a change occurred in the total useful life from 20 to 16 years with a salvage value of CU 2,200. Considering the usage of the straight-line depreciation approach, the depreciation expense becomes:

Computation:

Book value on January 01, 2019 (Initial cost)	CU 100,000
Less: accumulated depreciation	
(CU 100,000 – CU 2,000 / 20 years = CU 4,900 x 3 depreciated = CU 14,700)	(CU 14,700)
Book value	CU 85,300
Less: new salvage value	CU 2,200
Depreciable amount	CU 83,100

Depreciable amount/New life = CU 83,100 / 13 years = CU 6,392.30

Dr. Depreciation expense CU 6,392.30

Cr. Accumulated depreciation 6,392.30

A disclosure made for this kind of change would be:

The company has reviewed the estimations of the useful life of certain machines and facilities. Certain modifications were made to provide an improved reflection of the period estimation during which the asset will continue to operate. Thus, the change has resulted in an increase in the annual depreciation from CU 4,900 to CU 6,392.30 starting as of 2022.

Subject to paragraph IAS 8.23, when a change in accounting policy is applied retrospectively in accordance with paragraph IAS 8.19 (a) or (b), 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.

Example 2
Example on Changes in Accounting Policies

A German corporation has to switch the inventory valuation approach via FIFO to weighted averages because this better reflects the consumption pattern of the specific inventory. Balances of inventory for each approach were:

	FIFO	***Weighted Average***
January 1, 2020	CU 174,000	CU 177,000
December 31, 2020	CU 181,000	CU 183,000
The tax rate is 40%		
In its 2020 financial statements, what amount should it report as the cumulative effect of this accounting change?		
Weighted average method as of January 1, 2020, the year in which the change is adopted		CU 177,000
Less: FIFO method		CU 174,000
Cumulative effect of the change before taxes		CU 3,000
Cumulative effect, net of taxes: CU 3,000 (1-40%)		CU 1,800

A **note disclosure** should be provided when a change in accounting is deemed to be immaterial in practice in the present year but is likely to become significant in a later year.

The nature and the reasoning for such a change in policies, including an explanation as to why the new concept is better, should be stated in the Footnotes.

Errors can arise with respect to the recognition, measurement, presentation, or disclosure of elements from financial statements. Financial statements do not comply with International Financial Reporting Standards (IFRS) if they contain either material or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance, or cash flows. Potential current period errors discovered in that period are to be corrected before the financial statements are authorised for issue.

Example 3
Accounting Errors

Sun Corporation purchased Sweet Company on January 1, 2016. Patents were recorded in the amount of CU 100,000 and have not been amortised. The useful life of these patents was estimated at 20 years. The error correction at the end of 2018 is:

Dr. Amortisation expense		
(CU 100,000/20 years = CU 5,000 x 1 year for 2018)	CU 5,000	
Dr. Retained earnings		
(CU 5,000 x 2 years for 2016 and 2017)	CU 10, 000	
Cr. Patents		CU 15,000

Numerous errors can occur during the accounting process. Many of those errors will be discovered and corrected throughout the normal course of business. Some errors will be detected after the books have been closed for an accounting period, thereby requiring an adjustment to the Retained Earnings balance. Most errors that go undetected counterbalance over a 2-year period, but those that do not often require a cumulative adjustment once they have been detected. When an error is detected, all financial statements presented for comparative purposes are corrected and restated.

EXAMPLE 4

Errors in Closing Entries

A Manufacturing Company prepares the following three closing entries at the end of the year:
#1 Dr. Retained Earnings CU 65,350
    Cr. Service Revenue CU 65,350

#2 Dr. Retained Earnings CU 39,200
    Cr. Advertising Expense CU 10,400
    Rent Expense CU 4,500
    Salaries Expense CU 18,800
    Supplies Expense CU 4,500

#3 Dr. Retained Earnings CU 2,000
Cr. Dividends Payable CU 2,000

Required:
Identify the potential error(s) in the closing entries.

Solution:

1. This entry is backward. The correct entry would be:

Dr. Service Revenue		65,350	
	Cr. Retained Earnings		65,350

2. The debits do not equal the credits in this entry. Retained earnings should be debited for CU 38,200, not CU 39,200.

3. This entry is incorrect. Dividends Payable is not closed out at the end of the year. Only the normal Dividends account is credited in a closing entry.

DISCLOSURES

An entity shall provide a disclosure as referenced in IAS 8.28 when the initial application of an IFRS has an effect on the current period or any prior period, would have such an effect except that it is impracticable to determine the amount of the adjustment, or might have an effect on future periods.

An entity shall provide a disclosure as referenced in IAS 8.29 when a voluntary change in accounting policy has an effect on the current period or any prior period, would have an effect on that period except that it is impracticable to determine the amount of the adjustment, or might have an effect on future periods.

An entity shall provide a disclosure as referenced in IAS 8.30 when the entity has not applied a new IFRS that has been issued but is not yet effective.

An entity shall disclose the nature and amount of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods, except regarding the disclosure of the effect on future periods when estimating that effect is impracticable.

A good example of **Change in Reporting Entity** would be a partnership that changes its form to a corporation.
A note disclosure is also required that will involve the transformation and justification for the switch.

Following a business combination, the combined company must provide pro forma earnings and net income information for the year of the combination and the preceding year. Computations must be made to adjust the reported numbers to what they would have been had the combination occurred at the beginning of the preceding year.

The summary listed below presents the appropriate accounting procedures applicable to each of the four main categories covered in IAS 8.

Table 2. Summary of Procedures for Reporting Accounting Changes and Error Corrections

Category	Accounting Procedures
I. Change in estimate	1. Adjust either current period results or current and future period results. 2. Does not require a separate cumulative adjustment or restated financial statements.
II. Change in accounting policies	1. An entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions, unless an IFRS specifically requires or permits categorisation of items for which different policies may be appropriate. 2. If an IFRS requires or permits such categorisation, an appropriate accounting policy shall be selected and applied consistently to each category.
III. Pro Forma Disclosures after a Business Combination	1. Provide a supplemental disclosure for the year of the combination and the preceding year of revenues and net income as if the combination had occurred at the beginning of both the combination year and the preceding year.
IV. Error corrections	1. If an error is detected during a period, correct accounts through normal accounting cycle adjustments. 2. If an error is detected in a subsequent period, adjust for effect of material errors by making prior-period adjustments directly to the Retained Earnings balance for the years affected by those errors. If the error relates to a year that has not been presented in the financial statements, the Retained Earnings balance for the

earliest year presented is adjusted. Also correct each item presented in comparative financial statements.

3. Once an error is discovered in previously issued financial statements, the nature of the error, its effect on the financial statements, and its effect on the current period’s income and EPS should be disclosed.