Project **New items for initial consideration**

Topic **IAS 8 *Accounting policies, Changes in accounting Estimates and Errors* – Hierarchy of guidance to select an accounting policy**

Purpose of this paper

1. This paper considers a request for the IFRS Interpretations Committee, to clarify the guidance in IAS 8 regarding the use of management's judgement in developing and applying accounting policies, when a particular event, transaction or other condition is not specifically addressed by IFRSs.

2. This paper:
   (a) provides background information on the issue;
   (b) analyses the issue within the context of IFRSs;
   (c) includes the staff recommendation not to add this issue to the Committee's agenda
   (d) asks the Interpretations Committee whether they agree with the staff recommendation.

3. The submission is reproduced in full in Appendix B to this paper.

Background information

4. When a particular event, transaction or other condition is not specifically addressed by IFRS, IAS 8 sets out a hierarchy of guidance (hereinafter referred

to as 'IAS 8 hierarchy') to be considered in the selection of an accounting policy. The IAS 8 hierarchy is included in paragraphs 10-12 as follows:

> 10. In the absence of an IFRS that specifically applies to a transaction, other event or condition, management shall use its judgment 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, in that the financial statements:
>
> (i) represent faithfully the financial position, financial performance and cash flows of the entity;
>
> (ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;
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> (iii) are neutral, i.e. free from bias;
>
> (iv) are prudent; and
>
> (v) are complete in all material respects.
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> 11. In making the judgment described in paragraph 10, management shall refer to, and consider the applicability of, the following sources in descending order:
>
> (a) the requirements in IFRSs dealing with similar and related issues; and
>
> (b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Framework.
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> 12. In making the judgment described in paragraph 10, management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practices, to the extent that these do not conflict with the sources in paragraph 11 above.

5. The request specifically asks for clarification, when applying the IAS 8 hierarchy, on whether management is required to incorporate into an accounting policy:

    (a) only certain aspects of the treatment prescribed by IFRSs for similar transactions which management judges necessary to produce information that is relevant and reliable; or,

    (b) all aspects of the treatment prescribed by IFRSs for similar transactions regardless of the existence of a potential impact on the relevance and reliability of the information presented

Analysis of the issue

6. The requirements in paragraphs 10 –12 of IAS 8 give management guidance on developing accounting policies in the absence of a specific IFRS dealing with a certain transaction. In the staff's view:

   (a) paragraph 10 sets out the **principle** that management should develop and apply an accounting policy that results in reliable and relevant information; and

   (b) paragraphs 11 and 12 outline the **process** by which management develops accounting policies according to paragraph 10. Under this process, accounting policies are developed by judging all the sources contemplated in the IAS 8 hierarchy, including making **analogies** for similar transactions when appropriate as stated in paragraph 11(a) of IAS 8.

7. In the staff's view, analogies are useful when developing a relevant and reliable accounting policy for the transaction analysed. Developing an accounting policy through analogising to an IFRS dealing with similar and related issues:

   (a) aids consistency with how those similar and related issues are accounted for;

   (b) helps ensure the policy meets the relevance and reliability criteria described in paragraph 10 of IAS 8;

   (c) can be more efficient than developing a policy from a first-principles application of the Framework.

8. The staff thinks that in the development of an accounting policy by analogy, management should:

   (a) identify the principles in IFRSs that could be analogised to the transaction or event analysed;

   (b) consider and understand any scope exclusions in IFRSs; if a transaction has been scoped out, then the reason for that scope exclusion should be identified. This reason might prevent application by analogy, or may require some modification of the policy to take account of the reason for the scope exclusion;

(c) use its judgement to analyse the applicability of IFRSs by analogy, where appropriate, to develop an accounting policy that results in relevant and reliable information;

(d) justify why such principle applies to the transaction analysed and apply the principle in full, unless this will not produce reliable and relevant information; and

(e) if application by analogy is not feasible, consider other sources in the IAS 8 hierarchy.

9. IFRSs are developed through a formal system of due process and broad international consultation with the objective of producing high quality and useful information. Therefore, the requirements in IFRSs when applied in full, result in relevant and reliable information in line with paragraph 10 of IAS 8.

10. Each IFRS is developed to produce relevant and reliable information when applied in full. The omission of certain requirements from an IFRS when developing an accounting policy by analogy will call into question whether that policy meets the criteria set out in paragraph 10 of IAS 8. In the absence of a reason not to apply part of an IFRS that is otherwise being analogised to, the staff thinks that the entire IFRS should be applied.

Staff's view

11. The staff thinks that its analysis in paragraphs 6 to 10 above is a description of how it expects to see the requirements of IAS 8 applied, in particular, the importance of applying judgement in developing the accounting policy.

12. The submission raised specific questions concerning whether only certain aspects, or all aspects of an IFRS being analogised to should be included in the accounting policy being developed. The staff is of the view that this will depend on the nature of the specific transaction or event for which the accounting policy is being developed. The overriding objective will be that the accounting policy

produces relevant and reliable information, as described in paragraph 10(a)-(b) of IAS 8.

Agenda criteria assessment for the Committee

13. The staff's preliminary assessment of the agenda criteria is as follows:

    (a) *The issue is widespread and has practical relevance.*

    No.

    Based on the staff's limited outreach on this issue, the staff understands that the issue is not widespread.

    (b) *The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The Committee will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.*

    No. In the staff's opinion, significant diversity is not expected to occur in practice.

    (c) *Financial reporting would be improved through elimination of the diverse reporting methods.*

    Not applicable. In the staff's opinion, there is a prevalent view in practice.

    (d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process.*

    Yes. The staff does not think that there is a need to incorporate extra guidance to clarify the selection and application of accounting policies by analogy under the IAS 8 hierarchy.

    (e) *It is probable that the Committee will be able to reach a consensus on the issue on a timely basis.*

    Not applicable. In the staff's opinion, no formal interpretation is needed as far as the application of current IAS 8 is concerned.

    (f) *If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities. The Committee will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the Committee requires to complete its due process.*

No. There is no current or planned IASB project covering the issue.

Staff recommendation

14. The staff thinks that the process for developing accounting policies by analogy does not need to be clarified in paragraphs 10 –12 of IAS 8 as the current guidance is robust enough. In addition, the IAS 8 hierarchy involves the use of management's judgement to analyse the sources of information that management needs to rely on for determining an accounting policy, thus in the staff's opinion it would be unproductive to attempt providing further guidance or clarification in this respect.

15. Based on its assessment under the Committee's criteria , the staff does not recommend that the Committee should take this issue on the application of the IAS 8 hierarchy to its agenda.

Questions for the Committee
1. Does the Committee agree that the principles in IAS 8 (paragraphs 10 –12) are clear with regards to the selection and application of accounting policies in the absence of an IFRS that specifically applies to a transaction or other event? 2. Does the Committee agree with the staff's recommendation that the Interpretations Committee not add this issue to its agenda? 3. Does the Committee have any comments on the proposed wording for the tentative agenda decision in Appendix A?

Appendix A – Proposed wording for tentative agenda decision

A1 The staff proposes the following wording for the tentative agenda decision:

IAS 8 *Accounting Policies, Changes in Accounting estimates and Errors* – application of the IAS 8 hierarchy

The Interpretations Committee received a request for clarification of the guidance in IAS 8 regarding the use of management's judgement in developing and applying accounting policies, when a particular event, transaction or other condition is not specifically addressed by IFRSs.

The Committee observed that paragraphs 10 – 12 in IAS 8 provide clear guidance for management in developing and applying its accounting policies to ensure that this process results in information that is relevant to the economic decision-making process and reliable in the financial statements.

Therefore, the Interpretations Committee [decided] not to add the issue to its agenda.

Appendix B – Request for the Interpretations Committee agenda

A1. The staff received the following request. All information has been copied without modification, except for details that would identify the submitter of the request and details that are subject to confidentiality.

Submission to the IFRS Interpretations Committee

IFRSIC POTENTIAL AGENDA ITEM REQUEST

IAS 8: Application of IAS 8 Hierarchy

The issue

A2. IAS 8 prescribes the criteria for selecting accounting policies. IFRSs set out accounting policies that the IASB has concluded result in financial statements containing relevant and reliable information about the transactions, other events and conditions to which they apply. Accordingly, when an IFRS specifically applies to a transaction, other event or condition, the accounting policy or policies applied to that item should be determined by applying the IFRS and considering any relevant implementation guidance issued by the IASB for the IFRS.

A3. In some cases an IFRS will specifically exclude certain types of transactions from its scope of application. In other situations IFRS may fail to address, or choose to avoid, certain transactions or fact patterns. This may be done for specific reasons, such as concern that application of IFRS (to those transactions) may not result in relevant and reliable outcomes. When a particular event, transaction or other condition is not specifically addressed by IFRS, IAS 8 sets out a hierarchy of guidance to be considered in the selection of an accounting policy. The 'IAS 8 hierarchy' is set out in paragraphs 10-12 as follows:

> 10. In the absence of an IFRS that specifically applies to a transaction, other event or condition, management shall use its 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, in that the financial statements: (i) represent faithfully the financial position, financial performance and cash flows of the entity; (ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form; (iii) are neutral, i.e. free from bias; (iv) are prudent; and (v) are complete in all material respects.

> 11. In making the judgment described in paragraph 10, management shall refer to, and consider the applicability of, the following sources in descending order: (a) the requirements in IFRSs dealing with similar and related issues; and (b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Framework.
>
> 12. In making the judgment described in paragraph 10, management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practices, to the extent that these do not conflict with the sources in paragraph 11 above.

A4. When applying the IAS 8 hierarchy, to the extent that management develops an accounting policy having regard to the requirements of an IFRS that deals with similar and related issues, is management:

a) required to incorporate only those aspects of the treatment prescribed by the IFRS for similar transactions, which management judges necessary to ensure that the relevance and reliability objectives are satisfied; or

b) required to incorporate all aspects of the treatment prescribed by IFRS for similar transactions, notwithstanding the impact of certain elements on the relevance or reliability of the information presented?

Current practice:

View A

A5. The fundamental principle underlying the IAS 8 hierarchy is the use of judgment in developing and applying an accounting policy that results in information about the transactions, other events and conditions of the reporting entity that is relevant and reliable. To the extent that management develops an accounting policy having regard to the requirements of an IFRS that deals with similar and related issues, management is able use the IFRS as guidance and incorporate those aspects of the IFRS into an accounting policy that results in information that is relevant and reliable. Management should not be obliged, and in fact should be prohibited, from including other aspects of an IFRS which conflict with the objective of providing relevant and reliable outcomes. In exercising its judgment, management should have particular regard to the reasons why a certain type of transaction has not been dealt with or specifically excluded from an IFRS (for example, IASB doubts that the accounting would be relevant and reliable). A requirement to simply apply all aspects of an IFRS circumvents any scope exclusion (thereby rendering the scope exclusion ineffective) and is potentially inconsistent with the fundamental principle. This is particularly the case when management considers that such an application of IFRS does not result in information that is relevant in the circumstances.

View B

A6. A fundamental principle of IAS 8 is that management shall select and apply accounting policies consistently for similar transactions, other events and conditions of the reporting entity. To the extent that management has regard to the requirements of an IFRS that deals with similar and related issues and determines that a transaction, other event or condition is similar to those addressed by the IFRS, then management is required to apply all aspects of the treatment prescribed by the IFRS for such similar transactions. This ensures that transactions and other events involving similar and related issues are accounted for on a consistent basis. It is not appropriate for management to choose to apply certain aspects of an IFRS that is relevant to the transaction and ignore others. In summary, when selecting an accounting policy for transactions or other events that are not dealt with in IFRS, View A requires the use of judgment to develop a policy that results in information that is relevant and reliable whereas View B requires that a consistent application of IFRS for similar transactions in the belief that this will always result in information that is relevant and reliable.

Refer to the Appendix to this submission for an illustration of the different views.

Reasons for the IFRIC to address the issue:

A7. There are diverse views regarding the application of the IAS 8 hierarchy. The different views can result in significantly different accounting outcomes, as illustrated in the common control transaction example in the Appendix to this submission.

A8. We feel the IFRSIC should address the issue to ensure an appropriate interpretation of the IAS 8 hierarchy.

Appendix: Illustration of views about the application of the IAS 8 hierarchy

A9. Illustrative example: Business combination involving newly formed entity and non-controlling interests

A10. Note to IFRSIC members: Whilst this example deals with issues of accounting for combinations of entities or business under common control, we are not proposing an interpretation on this particular issue. The example is simply provided to illustrate the different views about the application of the IAS 8 hierarchy. Other types of transactions could be used to illustrate the principle.

A11. To illustrate an application of the two views identified above, consider a transaction in which two unrelated parties, A and B, each contribute a business to a newly formed entity, X, in return for an equity interest therein. A obtains a controlling interest in X while B obtains a non-controlling interest in X (i.e. X does not constitute a joint venture). It is noteworthy that a newly formed entity was used to effect the transaction in order to achieve commercial objectives (e.g. to separate the contributed businesses from other operations of A and B).

A12. How should X account for the acquisition of A's business and B's business in its own financial statements?

A13. Entity X is controlled by A. Accordingly, the issue of shares by X to acquire A's business represents a combination amongst entities or businesses under common control (i.e. A controls the business it transferred to X both before and after the transaction).

A14. Combinations of entities or businesses under common control are excluded from the scope of IFRS 3 Business Combinations. Entity X must therefore apply the IAS 8 hierarchy to develop and apply an accounting policy to its acquisition of A's business.

A15. Despite being excluded from the scope of IFRS 3, Entity X can look to IFRS 3 for guidance in developing an accounting policy[1].

A16. IFRS 3 prescribes the acquisition method. This involves the identification of the acquirer. To the extent that Entity X is identified as the acquirer, this would result in the identifiable assets acquired and liabilities assumed from A being recognised at their acquisition date fair values. Goodwill would also be recognised to the extent that the fair value of the consideration transferred (i.e. X shares) exceeded the fair value of the identifiable net assets acquired.

A17. However, IFRS 3 prohibits a newly formed entity that issues shares to effect a business combination from being identified as the acquirer. One of the combining entities that existed before the business combination is required to be identified as the acquirer. In this case, A would be identified as the acquirer. Accordingly, the assets and liabilities transferred by A would not be restated to their fair values. Instead, Entity X would recognise the assets and liabilities at their pre-combination carrying amounts without fair value uplift.

A18. On the other hand, the issue of shares by X to acquire B's business does not represent a combination amongst entities or businesses under common control. This business combination is included within the scope of IFRS 3. X would apply the acquisition method to its acquisition of B's business resulting in the identifiable assets acquired and liabilities assumed being recognised at their acquisition date fair values. Goodwill would

[1] The IASB has clarified that even though certain transactions or other events may be excluded from the scope of an IFRS, entities are permitted to refer to that IFRS for guidance in developing an accounting policy. (IASB Update September 2004).

also be recognised to the extent that the fair value of the consideration transferred (i.e. X shares) exceeded the fair value of the identifiable net assets.

A19. Therefore, if X were to apply IFRS 3 to its acquisition of A's business, this would result in the assets and liabilities of A's business being measured on a different basis compared to the assets and liabilities of B's business (i.e. the assets and liabilities of A are measured at pre-combination carrying amounts whilst the assets and liabilities of B are measured at their acquisition date fair values). The management of X does not consider that this provides relevant information to X's shareholders. Management consider that the recognition of both A and B's assets and liabilities at their acquisition date fair values provides more relevant information, as the relative fair values established and depict the respective ownership interests in X granted to A and B. It also ensures that profits reported and distributable by X to each of its shareholders are consistent with the valuation basis applied to the transactions to acquire A and B's businesses and consistent with the respective ownership interests of A and B in X.

View A

A20. While combinations of entities or businesses under common control are excluded from the scope of IFRS 3, X's management is able to look to IFRS 3 for guidance in developing an accounting policy that results in information that is relevant and reliable. Accordingly, management may choose to incorporate some, but not all, aspects of the acquisition method in its accounting policy for combinations of entities or businesses under common control. In particular, management may choose not to incorporate the requirements relating to the identification of the acquirer. Instead, the accounting policy could require that in such circumstances the newly formed entity (i.e. X) be identified as the acquirer. All other aspects of the acquisition method of accounting contained in IFRS 3 would be applied as they are considered to provide relevant and reliable information. As the acquirer, X would recognise the assets and liabilities of both A and B at their acquisition date fair values together with any goodwill (as appropriate). Such an accounting policy would be considered appropriate provided it satisfies the fundamental principle of providing information that is relevant and reliable. Management of X holds that view as the financial statements would recognise all acquired assets and liabilities on a basis consistent with the manner in which the ownership interests held by A and B were determined. It will also ensure that profits reported and entitlements on distribution are determined on a basis consistent with their respective ownership interests.

View B

A21. To the extent that management has regard to the requirements of an IFRS that deals with similar and related issues and determines that the same policy should be applied to similar transactions, then management is required to apply all aspects of the treatment prescribed by the IFRS. In this case, if management considered the acquisition method within IFRS 3 to be appropriate, then it is required to incorporate all aspects of the acquisition method in its accounting policy for combinations of entities or businesses under common control. Management cannot choose to apply certain aspects of the acquisition method and ignore others. This ensures that transactions and other events involving similar and related issues are accounted for on a consistent basis. This view results in the financial statements of X recognising the acquired assets and liabilities of A at A's historical basis, and the acquired assets and liabilities of B at their fair values. While this view might be relevant to A for the purpose of its consolidated financial statements, it may not be relevant to B or to A and B together as a collective shareholder group.