IFRS

STAFF PAPER

September 2014

IASB Meeting

Project	**IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors***
Paper topic	Distinction between a change in accounting policy and a change in accounting estimate

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Introduction

1. In November 2013 and March 2014, the IFRS Interpretations Committee (the Interpretations Committee) discussed a request from the European Securities and Markets Authority (ESMA) (the submitter) to clarify the criteria for distinguishing between a change in an accounting policy and a change in an accounting estimate, in relation to the application of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Purpose of this paper

2. The objective of this paper is to:

   (a) present background information on the issue;

   (b) provide a summary of the Interpretations Committee's discussions; and

   (c) set out the staff's rationale for recommending that the Disclosure Initiative should work on the issue.

Background information

3. The submitter states that enforcers have identified divergent practices regarding the assessment of whether a change qualifies as a change in an accounting policy, or as a change in an accounting estimate, in accordance with IAS 8.

4. The submitter points out that the distinction between a change in an accounting policy and a change in an accounting estimate is particularly important, because IFRS requires a different accounting treatment, resulting in application of the changes either prospectively or retrospectively. Moreover, IAS 8 sets out stricter criteria for a change in an accounting policy than for a change in an accounting estimate. According to paragraph 14(b) of IAS 8, in order to change an accounting policy, the issuer should be able to justify that the change provides more relevant information, whereas there is no such requirement for a change in an accounting estimate.

5. The submitter suggests that the criteria to distinguish a change in an accounting policy from a change in an accounting estimate should be clarified. In particular, the submitter suggests that the IASB should consider whether the reason for the change should be taken into account and, if so, on what basis.

6. The submitter gives specific examples in which it claims that distinguishing between a change in an accounting policy and a change in an accounting estimate is difficult:

   (a) a change in the method of calculation of own credit risk;

   (b) a change in an entity's method of assessment of High Quality Corporate Bonds (in relation to the recent Interpretations Committee discussion);

   (c) a change in the 'significant or prolonged' criteria used by an entity, which trigger impairment for available-for-sale equity instruments, in accordance with paragraph 61 of IAS 39 *Financial Instruments: Recognition and Measurement*;

(d) a change in the method of credit value adjustment (CVA) calculation, from historical approach to a market approach, in order to determine the probability of default and the loss given default; and

(e) a change in the inventory measurement formula from first-in first-out (FIFO) to a weighted average method.

7. Furthermore, the submitter states that there may be a need to clarify the interaction between the following paragraphs in different Standards:

(a) paragraph 66 of IFRS 13 *Fair Value Measurement* states that a change in a valuation methodology is a change in an accounting estimate;

(b) paragraph 35 of IAS 8 notes that a change in the measurement basis applied is a change in an accounting policy; and

(c) paragraph 118 of IAS 1 *Presentation of Financial Statements* states that measurement bases (for example, historical cost, current cost, net realisable value, fair value and recoverable amount) are accounting policies.

Staff analysis of the issue

Definition of a change in an accounting estimate and accounting policies

8. We think that the definition of a change in an accounting estimate in paragraph 5 of IAS 8 is relatively clear and changes should be assessed against the definition. However, we think that accounting policies are defined broadly and, as a result, the definition of accounting policies appears to overlap with the definition of a change in an accounting estimate:

> 5 Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.
>
> A change in an 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 result from new information or new developments and, accordingly, are not corrections of errors.

9. Accordingly, we do not think that the definitions themselves provide sufficient clarity to distinguish between the changes.

A change in the measurement basis

10. A change in the measurement basis applied is a change in an accounting policy, according to paragraph 35 of IAS 8:

> 35 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.

11. The question therefore arises as to what constitutes a change in measurement basis. We note that there is some useful guidance on this matter in IAS 1 (paragraph 118) and in IFRS 13 (paragraphs 2 and 62).

12. We note that paragraph 118 of IAS 1 gives examples of measurement basis as "historical cost, current cost, net realisable value, fair value or recoverable amount." We observe that fair value is identified in paragraph 118 of IAS 1 as one measurement basis. We further note that paragraphs 2 and 62 of IFRS 13 state:

> 2 For some assets and liabilities, observable market transactions or market information might be available. For other assets and liabilities, observable market transactions and market information might not be available. However, the objective of a fair value measurement in both cases is the same—to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions.
>
> 62 The objective of using a valuation technique is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability

would take place between market participants at the measurement date under current market conditions.

13. We note that paragraph 66 of IFRS 13 states that “revisions resulting from a change in the valuation technique or its application shall be accounted for as a change in an accounting estimate in accordance with IAS 8.”, which is consistent with the paragraphs above.

14. On the basis of the above assessment, we think that the paragraphs identified in the submission (referred in paragraph 7 of this paper) are consistent.

15. We conclude from this that a change in measurement basis, such as a change between historical cost and fair value, is a change in an accounting policy. We also note that a change in the valuation technique used, or in its application, while retaining the same measurement objective (eg a measurement objective of fair value) is 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

16. 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, according to paragraph 35 of IAS 8. However, we consider that sufficient analysis should be made before reaching that conclusion.

    (a) First of all, an assessment should be made to distinguish an error from a change in an accounting policy or a change in an accounting estimate. In accordance with paragraph 5 of IAS 8, changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

    In preparation for the Interpretations Committee’s discussion, we asked securities regulators and national standard-setters to provide us with information on any challenges they had experienced in relation to the distinction between a change in accounting policy and a change in accounting estimate. In response to the outreach, one regulator pointed out that they have noted instances in which the disclosures suggested that changes characterised as changes in estimates or policies may have been corrections of errors.

(b) Secondly, we note that there are some judgements made in the preparation of financial statements that result in changes to financial statements but that are not judgements related to estimates. We further note that there are specific disclosure requirements in respect of those judgements, in accordance with paragraph 122 of IAS 1:

> 122 An entity shall disclose, in the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations (see paragraph 125), that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

We consider that the change in the judgements is neither a change in accounting policy nor a change in accounting estimate. Paragraphs 123–124 of IAS 1 provide examples of such judgements as follows:

- 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;
- whether an entity controls another entity; and
- the criteria developed by the entity to distinguish investment property from owner-occupied property and from property held for sale in the ordinary course of business, when classification of the property is difficult.

Sufficiency of the existing guidance on distinction between a change in an accounting policy and a change in an accounting estimate

17. Although we noted that the Standards mentioned earlier provide some guidance to distinguish a change in an accounting policy and a change in an accounting estimate, the guidance does not necessarily solve the issues, for the following reasons:

(a) the definition of a change in an accounting estimate is relatively specific, but the definition of accounting policy is broad, and thus, the two definitions overlap.

(b) IAS 8 states that a change in the measurement basis applied is a change in an accounting policy; however, it is not clear in all circumstances what constitutes a change in the measurement basis, in particular whether a change in historical cost bases is a change in the measurement basis (for example, from FIFO to a weighted-average method) or merely a change in accounting estimate.

The Interpretations Committee's view

18. The Interpretations Committee noted that a change in an accounting estimate may encompass the following changes:

(a) a change in the inputs used to make the estimate; and

(b) a change in the method used to develop an accounting estimate.

19. The Interpretations Committee observed that it would be helpful if clear guidance was given about the circumstances in which changes in the method of estimation may be made.

20. The Interpretations Committee notes that IFRS provides criteria for a change in an accounting policy. In addition, similar criteria exist for a change in an accounting estimate resulting from a change in the valuation technique or its application under IFRS 13. However, such explicit criteria are not given for other changes in method used to develop an accounting estimate:

	Change in an accounting policy under IAS 8	Change in method used to develop an accounting estimate	
		A change in the valuation technique or its application	Other change in method for an accounting estimate
Justification for change required? (threshold)	An entity shall change an accounting policy only if the change results in the financial statements providing reliable and more relevant information (paragraph 14(b)).	A change in a valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances (paragraph 65).	No explicit guidance
Related disclosure requirement	The reasons why applying the new accounting policy provides reliable and more relevant information (paragraph 29(b)).	The reason for the change in the valuation technique (paragraph 93(d)).	N/A (Only the nature and amount of the change is required to be disclosed.) (IAS 8 paragraph 39)

21. During its discussions on this topic, some Interpretations Committee members noted that although it is not explicit in the Standards, a change in the method used to develop an estimate, should, by its nature, involve judgements similar to those for assessing a change in valuation technique in IFRS 13, and should not be a free choice.

22. The Interpretations Committee thinks that a change in the method used to develop an estimate should only be made if that change produces a reliable and equally or more relevant estimate, which will enhance the consistency between the existing IFRS 13 and IAS 8.

23. The Interpretations Committee, having considered the existing disclosures requirements, noted that the following requirements support useful, relevant disclosures about changes in the method of estimation used:

The Interpretations Committee also noted that paragraph 39 of IAS 8 requires disclosure of the nature and amount of a change in accounting estimate, and that such disclosure would include information about a change in the method used. The Interpretations Committee observed that information about the change in the method used would need to be disclosed in accordance with paragraph 39 of IAS 8 or, in the case of a change in valuation technique for a fair value measurement, in accordance with paragraph 93(d) of IFRS 13. [*IFRIC Update* March 2014]

24. On the basis of the discussion, the Interpretations Committee recommended that the IASB should amend IAS 8 to clarify the circumstances in which changes in the method of estimation may be made. In particular, the Interpretations Committee thought that a change in a method used to develop an estimate should only be made: if that change produces a reliable and equally, or more, relevant estimate.

Concerns about significant increase in disclosures

25. In response to the observation and recommendation by the Interpretations Committee, we conducted analysis for a disclosure on the change in method used. We are aware of concerns about a potential significant increase in disclosures if additional disclosures are required on a change in an accounting estimate. For example, large financial institutions may use many methods to develop estimates for impairment provisions and may continuously improve these methods used to develop their estimates. Some have expressed concern that if disclosures are required for all those changes in methods used, it could significantly increase disclosures.

26. We consider that the disclosure of a change in method used to develop an estimate should be provided only if the change has a material effect that could influence users' decisions. However, we understand the concerns and consider that

threshold of the disclosure requirements should be made clear as part of any amendment. We note that 'Materiality' is currently considered by the Disclosure Initiative and the issue could interact with the Disclosure Initiative.

27. We discussed the issue with the Disclosure Initiative team to understand how the Interpretations Committee's recommendation interacts with the current projects of the Disclosure Initiative. We noted that the Principles of Disclosure project, which forms part of the Disclosure Initiative, is planning to consider an overall disclosure principle for 'consistency and comparability'. The disclosure requirements that relate to a change in an accounting policy and a change in an accounting estimate are expected to be considered when developing the principle.

28. In addition, we note that under the umbrella of the Disclosure Initiative, the IASB plans to work with a national standard-setter to review current transition requirements in IFRS. This review will consider how often and in what circumstances full retrospective application of a new Standard is required, compared to the circumstances in which modifications require full retrospective application. This research may inform the IASB about the distinction between accounting policies and estimates.

29. On the basis of the discussion, we consider that the issue of distinguishing between a change in accounting policy and accounting estimate should be incorporated into the Disclosure Initiative, rather than proposing a separate narrow-scope amendment.

Staff recommendation

30. The Interpretations Committee thought that the issue would benefit from greater clarity and guidance to help distinguish a change in an accounting policy from a change in an accounting estimate. The Interpretations Committee also thinks that users would benefit if entities explained changes in an accounting estimate in

which the change was as a consequence of a change in the method used to make the estimate.

31. We recommend that the issue about distinguishing between a change in an accounting policy and a change in an accounting estimate, and any applicable thresholds and disclosures, should be considered as part of the Disclosure Initiative.

Questions for the IASB
Does the IASB agree with the staff's recommendation that this issue should be considered in the Principles of Disclosure project and in the additional work on the transition requirements in IFRS, both of which form part of the Disclosure Initiative?

Appendix A—Original agenda request

A1. The IFRS Interpretations Committee received a request for clarification to distinguish between a change in an accounting policy and a change in an accounting estimate from ESMA as follows:

Mr Wayne Upton
IFRS IC
Cannon Street 30
London EC4M 6XH United Kingdom

Agenda item request: Application of IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors to distinguish between a change in accounting estimate and a change in accounting policy

Dear Mr Upton,

The European Securities and Markets Authority (ESMA) is an independent EU Authority that contributes to enhancing the protection of investors and promoting stable and well-functioning financial markets in the European Union (EU). ESMA achieves this aim by building a single rule book for EU financial markets and ensuring its consistent application across the EU. ESMA contributes to the regulation of financial services firms with a pan-European reach, either through direct supervision or through the active coordination of national supervisory activity.

As a result of the enforcement activities carried out by national competent authorities ESMA has identified an issue related to the application of IAS 8 – *Accounting Policies, Changes in Accounting Estimates and Errors,* which we would like to bring to the attention of the IFRS Interpretations Committee for adding it to its agenda.

A detailed description of the issue is set out in the appendix to this letter. We would be happy to further discuss this issue with you.

Yours sincerely,

Steven Maijoor
Chair
European Securities and Markets Authority

APPENDIX- DETAILED DESCRIPTION OF THE ISSUE

1. Enforcers have identified divergent practices regarding the assessment of whether a change qualifies as a change in an accounting policy or as a change in an accounting estimate in accordance with IAS 8, as illustrated in the examples below.

Description of the issue

2. The distinction between a change in accounting estimate and a change in accounting policy is particularly important because IFRS requires a different accounting treatment resulting in application of the change prospectively or retrospectively.

3. Moreover, IAS 8 sets out stricter criteria for changes in accounting policy than for changes in accounting estimate. According to paragraph 14(b) of IAS 8, in order to change an accounting policy the issuer should be able to justify that the change provides more relevant information, whereas there is no such requirement for a change in accounting estimate.

4. Recent debates at the IFRS IC on the request for guidance on the determination of the rate used to discount post-employment benefit obligations show that IFRS IC members were divided on the qualification of a change of the way to determine a discount rate. The November 2012 IFRS IC Update[1] states that *"the Interpretations Committee briefly discussed, but did not conclude, on whether a change to the way in which an entity determines the discount rate would be a change in accounting policy or a change in estimate".*

5. ESMA is concerned that diversity in practice may exist regarding this qualification. ESMA provides the following examples to illustrate the ambiguities arising from the assessment whether a change qualifies as a change in accounting policy or as a change in accounting estimate.

Example A - Change in the own credit risk calculation

6. Historically, bank A computed its own credit risk for the measurement of its financial liabilities at fair value using credit default swap (CDS) curves. Following the financial crisis and the dislocation of the CDS market, bank A modified its methodology and assessed its own credit risk at year-end based on the spread of its most recent debt issuance.

[1] IFRS IC Update — November 2012, IFRS Foundation, November 2012

View1

7. Supporters of view 1 believe that this change is a change in accounting policy, as the basis for determining the own credit risk changed from CDS curve method to a methodology based on the spread of the historical debt issuances.

View2

8. Supporters of view 2 argue that this is a change in accounting estimate because the objective of the accounting policy related to the measurement of own credit risk has not changed. The method of valuation was modified as the CDS curve was no longer relevant. Hence, according to this view, this change is due to *"changes which occurred in the circumstances on which the estimate was based"* as referred to in paragraph 34 of IAS 8.

Example B - Change in the definition of High Quality Corporate Bonds

9. The subject was briefly discussed during the November IFRS IC meeting as part of the discussion on high quality corporate bonds (HQCB) in IAS 19 and IFRS IC members expressed diverging views on whether such change would qualify as a change in accounting policy or a change in accounting estimate.

View1

10. Proponents of view 1 believe that a change in the reference used to determinate the discount rate is a change in accounting policy because the measurement basis used in determining the discount rate changed. If an issuer used in the past the yield of AA-rated bonds, switching to the yield of BBB- rated bonds is a change in the measurement basis.

11. They argue that the change is not a change in accounting estimate because the issuer had chosen AA-rated bonds as a definition for HQCB. Changing the definition of a concept cannot be a change in estimate.

View2

12. Proponents of view 2 argue that this change is not a change in accounting policy because the objective which is to determine the discount rate with the reference to the yield of HQCB did not change (i.e. there was no change in measurement basis). The fact that the yield of HQCB was formerly evaluated using AA-rated bonds and is now evaluated using BBB-rated bonds is a change in accounting estimate. The number of AA-rated entities is no longer sufficient and consequently it is more relevant to use BBB-rated bonds. Hence, this change is due to *"changes which occurred* in *the circumstances on which the estimate was based"* as referred to in paragraph 34 of IAS 8.

Other examples

13. ESMA notes other examples where the assessment whether a change qualifies as a change in accounting policy or as a change in accounting estimate is difficult:

    a. a change in the *"significant or prolonged"* criteria which trigger impairment for Available for Sale equity instruments in accordance with paragraph 61 of IAS 39 - *Financial Instruments: Recognition and Measurement,*

    b. a change of method of credit value adjustment (CVA) calculation, from historical approach to determine the probability of default and the loss given default to market based approach,

    c. a change in the measurement formula of the cost of the inventories from first-in-first-out (FIFO) to weighted average cost.

Request

14. ESMA would suggest that the criteria to distinguish a change in accounting policy from a change in accounting estimate need to be clarified. In particular, ESMA suggests the IASB to clarify whether the reason to justify the change should be taken into account (e.g. voluntary change or change due to external circumstances) and if so on what basis.

15. Furthermore, ESMA finds that there might be a need to clarify the interaction between the following paragraphs in different IFRSs:

    - paragraph 66 of IFRS 13 -*Fair Value Measurement* which states that a change in a valuation methodology is a change in accounting estimate,

    - paragraph 35 of IAS 8 which notes that a change in the measurement basis applied is a change in accounting policy, and

    - paragraph 118 of IAS 1 – *Presentation of Financial Statements* which states that measurement bases (e.g. historical cost, current cost, net realisable value, fair value and recoverable amount) are accounting policies.