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STAFF PAPER

May 2015

IASB Meeting

Project	**Disclosure Initiative–Principles of Disclosure (POD)**		
Paper topic	Distinction between changes in accounting policies and changes in accounting estimates		
CONTACT(S)	Leonardo Piombino	lpiombino@fondazioneoic.it	+39 06 6976 6834
	Tommaso Fabi	tfabi@fondazioneoic.it	+39 06 6976 6829
	Nadia Chebotareva	nchebotareva@ifrs.org	+44 (0) 20 7246 6457

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OIC STAFF PAPER prepared for the May 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

Introduction and purpose of the paper

1. In September 2014 the IFRS Interpretations Committee informed the IASB about divergent practices regarding the assessment of whether a change represents a change in an accounting policy, or a change in an accounting estimate, in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

2. In that meeting, the IASB decided that the issue of potential amendments to definitions of accounting policies and of a change in accounting estimate should be considered as part of the *Disclosure Initiative*.

3. The purpose of this paper is to:

   (a) propose how to clarify the existing distinction between a change in an accounting policy and a change in an accounting estimate;

   (b) propose to include this clarification in the forthcoming Discussion Paper on *Principles of Disclosure*; and

   (c) ask IASB members whether they agree with our proposals.

Background information

Why this issue is relevant

4. The distinction between a change in accounting policy and a change in accounting estimate is relevant, because requirements of IAS 8 for how to reflect a change in accounting policy and a change in accounting estimate are different. Namely:

    (a) Entities apply voluntary changes in accounting policy retrospectively (ie comparative amounts are restated as if the new accounting policy had always been applied); while changes in accounting estimates are applied prospectively (ie in the period of change).[1]

    (b) A change in accounting policy is allowed only if the change is required by an IFRS or results in financial statements providing reliable and more relevant information.[2] There is no such requirement in IAS 8 for changes in accounting estimates.

Our findings

5. The main feedback received as a result of the surveys and outreach is as follows.

6. When the change relates to measurement, it is sometimes difficult on the basis of the existing definitions to distinguish between changes in accounting policies and changes in accounting estimates. One-third of the respondents to the preparers' survey said that they had experienced problems with the distinction between accounting policies and accounting estimates. Respondents provided the following examples related to measurement:

    (a) a change in valuation method used for inventories (from FIFO to average weighted cost);

    (b) a change in the method of fair value valuation;

    (c) a change in the impairment criteria for equity instruments; and

[1] Paragraphs 36 and 37 of IAS 8.
[2] Paragraph 14 of IAS 8.

(d) a change in the determination of the discount rate for defined benefit obligations.

Analysis of these and other examples is included in Appendix A.

7. The existing definition of accounting policies in IAS 8 (paragraph 5) is too broad and it appears to overlap with the definition of a change in accounting estimate.

> *Accounting policies* are the specific principles, bases, conventions, rules and 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 result from new information or new developments and, accordingly, are not corrections of errors.

8. Based on the results of our surveys and outreach activities, the majority of the preparers believe that:[3]

(a) changes in a measurement basis should be presented retrospectively; and

(b) changes in the method used to make an estimate, changes in the inputs and assumptions and other changes related to measurement should be presented prospectively.

Our proposal

9. On the basis of the feedback received, we propose to amend IAS 8 in order to clarify that:

[3] See the summary of the Global Preparers Forum meeting in March 2015 http://www.ifrs.org/Meetings/MeetingDocs/Other%20Meeting/2015/March/GPF-meeting-summary-March-2015.pdf

(a) changes in the measurement bases that are specified in relevant Standards are changes in accounting policies;

(b) changes in inputs, assumptions and methods that are used to make an accounting estimate are changes in accounting estimates; and

(c) changes in the methods used to determine different amounts of cost are changes in accounting policies.

10. Consequently, we propose to amend the definitions of accounting policies and changes in accounting estimates as follows (new text is underlined, deleted text is struck through).

> *Accounting policies* are the specific principles, ~~bases, conventions,~~ rules, measurement bases specified in relevant IFRSs and practices applied by an entity in preparing and presenting financial statements. Changes in methods that have been used to determine different amounts of cost are changes in accounting policies.

> and

> 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 include changes in inputs and assumptions that have been used in earlier estimations. They result from new information or new developments and, accordingly, are not corrections of errors. Changes in accounting estimates also include changes in methods that have been used in earlier estimations.

11. We think that our proposal is consistent with paragraph 35 of IAS 8, because it already states that:

> 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.

12. In our view, accounting estimates, by their nature, relate only to measurement of items in financial statements. This is unlike accounting policies, which, in addition to measurement bases, also include specific principles and rules for recognition, classification and presentation of items in financial statements.

13. We think that the proposed clarified distinction between policies and estimates:

    (a) is easy to apply (the driver is whether or not the required measurement basis or the type of cost has changed);

    (b) increases consistent application, solving the issues recently submitted to the IFRS Interpretation Committee (see examples 1–5 in Appendix A) and the issues raised by the respondents to the survey;

    (c) would not significantly undermine information for users, because changes in measurement bases (which are fundamental changes) will be applied retrospectively;

    (d) is consistent with the feedback received; and

    (e) is in line with the existing requirements (ie it is a clarification rather than a fundamental change).

14. It is also worth pointing out that some Standards are more explicit than others about how changes in a measurement basis or in a measurement method should be treated. This is something that the IASB might want to consider in its future standard-setting practice. For example, IAS 16 and IFRS 13 provide some explicit guidance, which is summarised in Appendix A.

15. It is also important to investigate whether new disclosures should be required when an entity changes a method to make an estimate in addition to what is already required in IAS 8.[4] This is discussed in a separate paper; see Agenda Paper 11B.

[4] Paragraph 39 of IAS 8 states that: *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 for the disclosure of the effect on future periods when it is impracticable to estimate that effect*.

Location of the proposal

16. We believe that our proposal should be included in the forthcoming Discussion Paper *Principles of Disclosures*. We also considered whether this proposal should be included in a separate narrow-scope amendment to IAS 8 (ie a separate Exposure Draft). However, we rejected the second option, because the issue deals with amendments to the definitions of 'accounting policies' and 'a change in accounting estimate'. It is necessary to ensure that the proposed changes will not produce unintended consequences. We believe that the Discussion Paper process will provide more opportunity for feedback and discussion.

Specific considerations

Measurement bases specified in relevant IFRSs[5]

17. We propose to add 'measurement bases specified in relevant IFRSs' to the definition of accounting policies, because we believe that each Standard identifies a measurement basis (or bases) that should apply for measurement of transactions within its scope. For example, according to IAS 16 *Property, Plant and Equipment*, after recognition, an item of property, plant and equipment should be measured either at cost or fair value.

Do we need 'practices' in the definition of accounting policies?

18. We believe that we should not remove 'practices' from the definition of accounting policies. In our view, at the moment, accounting policies sometimes include practices that entities apply when there is no specific guidance in IFRSs; for example, capitalisation thresholds that expense rather than capitalise small value assets on acquisition. It is arguable that this practice is a policy and we think that removing the word practice could imply that there is a fundamental difference between the two.

Methods to determine different amounts of cost

19. We propose to add 'Changes in the methods that have been used to determine different amounts of cost are changes in accounting policies' to the definition of

[5] Paragraph 118 of IAS 1 provides examples of the following measurement bases: historical cost, current cost, net realisable value, fair value or recoverable amount.

accounting policies. This is because we believe that a change in the components, and hence definition, of cost is different from a change in the method used to make an estimate of a current value measure (such as fair value). In the case of cost, a new and different figure is being calculated as a result of a change in what comprises cost. For example, if an entity changes from FIFO to weighted average cost, or capitalises an expenditure that it previously recognised as an expense, it determines a different amount of cost. However, in the case of an estimate of fair value the definition of fair value is not changing. For example, if an entity changes from a market approach to an income approach to measure a Level 3 fair value any differences in the measurement are attributable to changes to the estimate. The definition of fair value remains exactly the same.

Changes in the method used to make an estimate should be permitted only if the change results in more relevant information

20. Under this view, changes in the method used to make an estimate are changes in accounting estimates, which is consistent with the proposal. The difference is that proponents of this view propose that these changes should be made only if a change results in more relevant and reliable information.

21. We rejected this approach, because we believe that this approach would be too restrictive and burdensome. Indeed, it may be difficult to demonstrate whether the change results in more relevant information. In our view, an entity should be permitted to change the method it uses to make an estimate when, for example, the new method is less costly or time-consuming (provided that it still provides reliable information).

22. In addition, as explained in more detail in Agenda Paper 11B, we propose additional disclosures for changes in accounting estimates that have a material effect on an entity's financial statements.

Other approaches considered but rejected

Distinction based on whether new information becomes available

23. Under this approach the distinction between accounting policies and estimates should be based on whether or not a change is a result of new information.

24. Consequently, a change that is *not* caused by new information would be considered as a change in accounting policy. In other words, if an entity changes a method for determining an amount of an item in the financial statements, this would automatically be considered a change in accounting policy.

25. We rejected this approach, because we think that it is not always easy to understand whether a change is a result of new information. For example:

    (a) some could argue that a change in the basket of High Quality Corporate Bonds (HQCB) used to determine the discount rate (eg from AA-rated bonds to A-rated bonds) could be the result of new information. In their view, the new information is that the number of AA-rated bonds is no longer sufficient to determine the discount rate;

    (b) others could argue that changing the definition of HQCB is a decision by the management and thus it is not caused by new information; and

    (c) others could say that the decrease in the number of AA-rated bonds is not sufficient to justify the change.

Options included in the Standards are always accounting policies

26. Under this approach, all the options mentioned in the Standards would be accounting policies.

27. We rejected this approach, because in some cases this conclusion is not consistent with the measurement bases required in the Standards. Under this approach changes in accounting policy would include changes that represent changes in accounting estimates, such as:

    (a) a change in the valuation technique to measure fair value, eg from a market approach to an income approach[6]; and

    (b) a change in the depreciation method, for example, from the straight-line depreciation method to the units-of-production depreciation method[7].

[6] IFRS 13 paragraph 66 states that: *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…*

Questions to IASB members

1. Do you agree that changes in inputs, assumptions and methods that are used to make an estimate are changes in accounting estimates?
2. Do you agree that a change in the method that has been used to determine different amounts of cost is a change in an accounting policy?
3. Do you agree that this issue (ie amendments to definitions of accounting policies and a change in accounting estimate) should be part of the forthcoming Discussion Paper *Principles of Disclosure*?

[7] IAS 16 paragraph 61 states that: *The depreciation method applied to an asset shall be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method shall be changed to reflect the changed pattern. Such a change shall be accounted for as a change in an accounting estimate in accordance with IAS 8*.

Appendix A—Examples of how the proposal applies to different changes

A1. In July 2013, the IFRS Interpretations Committee ('the Interpretations Committee') received a request from the European Securities and Markets Authority (ESMA) to clarify the criteria to distinguish between a change in an accounting policy and a change in an accounting estimate, in relation to the application of IAS 8. In the following table we apply our proposal to the issues raised by ESMA.

Example of a change	Standard	Reasons and conclusions behind the proposal
1. A change in the basket of high quality corporate bonds (HQCB) used to determine the discount rate for a defined benefit obligation, eg from AA-rated bonds to A-rated bonds.	IAS 19	Measurement basis—ie present value—has not changed **Estimate**
2. A change in the assessment of own credit risk for measurement of financial liabilities at fair value; eg from using a credit default swap curve to using the spread of the most recent debt issuance.	IFRS 13	Measurement basis—ie fair value—has not changed. **Estimate**
3. A change of credit value adjustment (CVA) calculation to determine the probability of default.	IFRS 13	Measurement basis—ie fair value—has not changed. **Estimate**
4. A change in the cost formula used for inventories: from FIFO to weighted average cost.	IAS 2	Measurement basis—ie cost—has not changed. However, the method to determine the amount of cost has changed. **Policy**
5. A change in the 'significant or prolonged' criteria for impairment of financial assets.	IAS 39	Measurement basis—ie present value for financial assets carried at amortised cost/cost and fair value for available-for-sale financial assets—has not changed. **Estimate**

A2. In the following table we show that our proposal is consistent with the existing requirements on changes in accounting policies and estimates.

Example of a change	Standard	Reasons and conclusions
6. A change in the depreciation method: from straight-line to the units-of-production method when the expected pattern of consumption has changed.	IAS 16	Measurement basis—ie cost, or fair value, less accumulated depreciation —has not changed. Paragraph BC33 of IAS 16 states that: *The Board considered how an entity should account for a change in a depreciation method. The Board concluded that a change in a depreciation method is a change in the technique used to apply the entity's accounting policy to recognise depreciation as an asset's future economic benefits are consumed. Therefore, it is a change in an accounting estimate.* **Estimate**
7. A change from the cost model to the revaluation model for measuring a class of property, plant and equipment.	IAS 16	Measurement basis—ie cost—has changed. Paragraph 29 of IAS 16 states that: *An entity shall choose either the cost model in paragraph 30 or the revaluation model in paragraph 31 as its accounting policy and shall apply that policy to an entire class of property, plant and equipment.* **Policy**
8. A change in the valuation technique to measure fair value, eg from a market approach to an income approach (Level 3).	IFRS 13	Measurement basis—ie fair value—has not changed. 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 accounting estimate in accordance with IAS 8.* **Estimate**
9. A change in the option pricing model for share options from Black and Scholes to Monte Carlo.	IFRS 2	Measurement basis—ie grant date fair value—has not changed. Paragraph B4 of IFRS 2 states that: *If traded options with similar terms and conditions do not exist, the fair value of the options granted shall be estimated by applying an option pricing model.* **Estimate**
10. A change in the expenditures included in the initial measurement of exploration and evaluation assets.	IFRS 6	Measurement basis—ie cost—has not changed. However, the method to determine the amount of cost has changed. **Policy** Paragraphs 8 and 9 of IFRS 6 state that:

Example of a change	Standard	Reasons and conclusions
		8. *Exploration and evaluation assets shall be measured at cost.* 9. *An entity shall determine an accounting policy specifying which expenditures are recognised as exploration and evaluation assets and apply the policy consistently. In making this determination, an entity considers the degree to which the expenditure can be associated with finding specific mineral resources. The following are examples of expenditures that might be included in the initial measurement of exploration and evaluation assets (the list is not exhaustive):* *(a) acquisition of rights to explore;* *(b) topographical, geological, geochemical and geophysical studies;* *(c) exploratory drilling;…*
11. Inventory has been measured at cost but it has become obsolete and its net realisable value (NRV) is lower than cost.	IAS 2	Measurement basis—ie the lower of cost or NRV—has not changed. **Estimate**