IFRS

STAFF PAPER

April 2018

ASAF Meeting

Project	Accounting policies and accounting estimates		
Paper topic	Illustrative examples		
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Purpose of the paper

1. The purpose of the paper is to discuss how, and if at all, the Board should proceed with illustrative examples in its amendments to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Background

2. The International Accounting Standard Board (Board) published the Exposure Draft *Accounting Policies and Accounting Estimates* (Proposed amendments to IAS 8) (Exposure Draft) in September 2017.

3. The Exposure Draft was open for comment for 120 days, the comment period ended on 15 January 2018. The Board received 82 comment letters and staff held one outreach meeting. The Board discussed the feedback summary to the Exposure Draft at its March 2018 meeting.[1]

4. In summary:

   (a) Almost all respondents state that the proposals in the Exposure Draft would provide more clarity on how accounting policies relate to accounting estimates.

[1] You can find the paper with the feedback summary at:
http://www.ifrs.org/-/media/feature/meetings/2018/march/iasb/ap26-feedback-summary.pdf

(b) Some respondents, however, question whether the proposals would result in sufficient improvements to make it appropriate for the Board to finalise the proposals.

(c) Many respondents state that having more illustrative examples would provide more clarity on the distinction between accounting policies and accounting estimates.

Structure

5. The agenda paper is structured as follows:

(a) Definition of accounting policies (paragraphs 6–8)

(b) Adding illustrative examples (paragraphs 9–0).

Definition of accounting policies

6. The existing definition of accounting policies in IAS 8 includes five terms—‘principles’, ‘bases’, ‘conventions’, ‘rules’ and ‘practices’. The Board did not propose substantially revising the definition of accounting policies. Instead, to make the definition clearer and more concise, the Board proposed:

(a) removing from the definition the terms ‘conventions’ and ‘rules’. By doing this, the Board did not intend to make the definition narrower or broader; instead it wished to provide more clarity;

(b) referring to ‘measurement bases’ instead of ‘bases’; and

(c) keeping the term ‘practices’. This is because the Board thought that referring to ‘principles’ only might be perceived as making the definition of accounting policies too narrow.

7. Many respondents agree with the overall proposal. One of the main comments relates to keeping the definition of accounting policies at a high conceptual level. Some respondents say:

> While the amendments focus primarily on the definition of accounting estimates, the proposed definition of accounting policies continues to use terms that contribute to existing

diversity because they are ambiguous and open to differing interpretations.[2]

8. However, none of the respondents provided a recommendation for a new definition of accounting policies.

Adding illustrative examples

9. Adding to IAS 8 illustrative examples of accounting policies and accounting estimates was a common request. Many respondents believe that adding further illustrative examples of accounting policies and accounting estimates will further clarify the distinction between accounting policies and accounting estimates. Some respondents express doubts about whether the Standard will be understandable without illustrative examples.

10. In the staff's opinion, if the Board decides to proceed with the amendments, it will need to address the following questions about illustrative examples:

    (a) whether to provide illustrative examples in the final guidance; and,

    (b) if yes, in what format.

11. Based on our understanding of feedback in comment letters, the main area where respondents want to see more illustrative examples is accounting policies. The reasons for this are as follows:

    (a) the existing and the proposed amended definition of accounting policies in IAS 8 define accounting policies at a very high conceptual level, ie as principles and measurement bases;

    (b) in fact, accounting policies arising from IFRS Standards are much more nuanced than, for example, simply using measurement bases of cost or fair value. Please see the illustrative example below; and

    (c) paragraph 32 of IAS 8 provides several examples of accounting estimates but does not provide any examples of accounting policies.

12. However, none of the respondents provided examples of illustrative examples.

[2] Comment letter from KPMG.

13. Our experience with this project has shown that it can be difficult to create helpful illustrative examples for this topic. This is because conclusions in illustrative examples are sensitive to specific facts.

14. Nevertheless, we thought that one possible way of providing illustrative examples of accounting policies might be to have an illustrative example that demonstrates the thought process for distinguishing accounting policies from accounting estimates, as opposed to giving answers to specific situations. The following example demonstrates this approach:

Example

Entity A has the following accounting policy for its inventories:

Inventories are stated at the lower of cost and net realisable value.

Net realisable value is the estimated selling price for inventories less all estimated costs of completion and costs necessary to make the sale.

Note: the example deals only with inventories that are not interchangeable. It does not discuss the selection of a cost flow formula for inventories that are interchangeable.

Accounting estimates used in applying the accounting policy

In applying this accounting policy for its inventories Entity A uses accounting estimates for the following inputs because they cannot be measured with precision and involve the use of judgements or assumptions.

Paragraph 10 of IAS 2 states that the cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

In converting materials into finished goods, Entity A incurs some fixed production overheads, such as depreciation and maintenance of factory buildings and equipment used in the production process, and the cost of factory management and administration. As part of its accounting policy in accordance with paragraphs 10 and 12 of IAS 2, in determining the costs of conversion of inventories, Entity A includes fixed production overheads in the cost of its inventories.

In doing so, Entity A determines the basis for allocating fixed production overheads. Production overheads are usually incurred centrally and they cannot be allocated with precision to individual items of inventories unlike, for example, costs of purchasing items that are not interchangeable. Paragraph 14 of IAS 2 says that when the costs of conversion of each project are not separately identifiable, they

are allocated between the products on a rational and consistent basis, for example based on the relative sales value of each product. Consequently, Entity A needs to select the basis (ie the type of costs and the allocation method) for allocating overheads to determine the cost of inventories. Selecting the basis for allocating overheads involves the use of judgement or assumptions to estimate the amounts of overheads attributable to items of inventory. Thus, selecting that basis constitutes making an accounting estimate. In assessing net realisable value, Entity A might also need to estimate: - the selling price for inventories; and - costs of completion and costs necessary to make the sale.

15. We would appreciate if ASAF members comments, about the Example could deal separately with:

(a) the approach to illustrative examples – our main focus; and

(b) contents of the Example.

Questions for ASAF members

Questions
1. Do you consider it is feasible to provide illustrative examples?
2. If yes, in what format?