TOPIC 32

INDAS - 8
ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES & ERRORS

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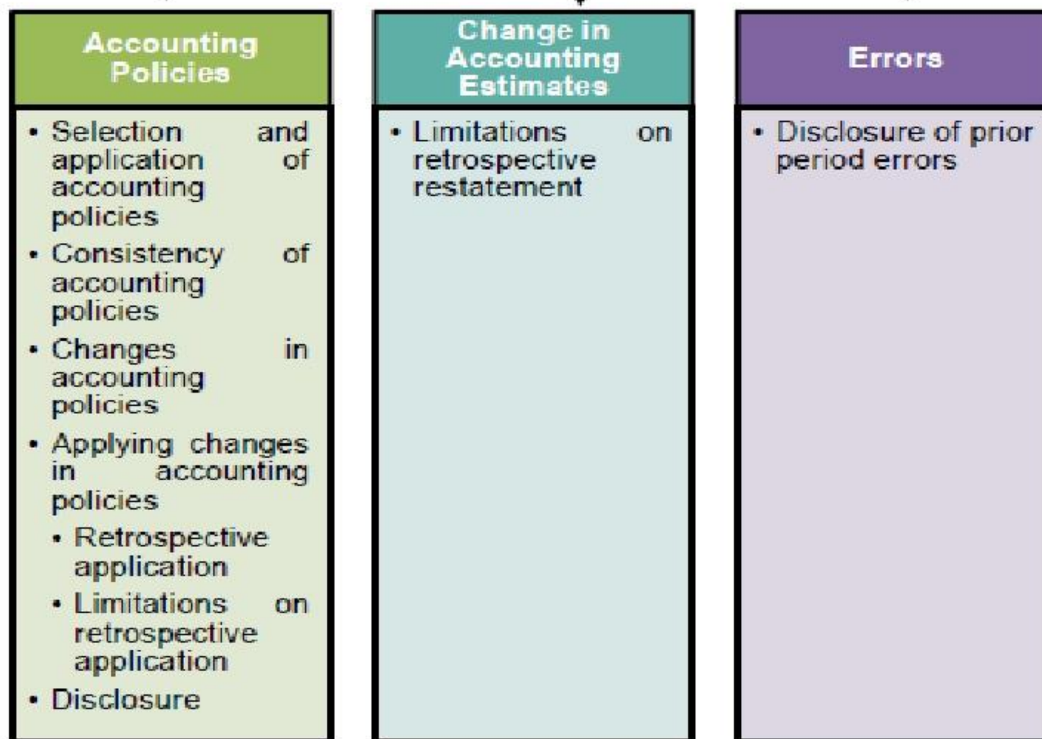
Quote:- Every day is another chance to change your life



Accounting policies, estimates and errors play a major role in the presentation of financial statements. That is the reason, Ind AS 1, clearly states that an entity cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material. If there is any change in accounting policies, that need to be dealt with due diligence and not just by mere note or explanation.

Further, Ind AS 1, makes it compulsory for the entity to present the 3 financial statements instead of 2, if there is any change in accounting policy which needs to be disclosed retrospectively.

SCOPE

This Standard shall be applied in

- selecting and applying accounting policies, and
- accounting for changes in accounting policies,
- changes in accounting estimates and
- Corrections of prior period errors.

However, tax effects of retrospective changes are not dealt with in this standard. Those changes are dealt with Ind AS 12 'Income Taxes'.

DEFINITIONS

1. **Accounting policies** are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

2. **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.

3. **Indian Accounting Standard** are Standards prescribed under Section 133 of the Companies Act, 2013.

4. **Material Omissions or misstatements** of items are material if they could, individually or collectively; influence the economic decisions that users make on the basis of the financial statements.

   Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

5. **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 approved 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.

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Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

6. **Retrospective application** is applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied.

7. **Retrospective restatement** is correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred.

8. **Impracticable:** Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. For a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if:
   (a) the effects of the retrospective application or retrospective restatement are not determinable;
   (b) the retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period; or
   (c) the retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:
      (i) provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosed; and
      (ii) Would have been available when the financial statements for that prior period were approved for issue from other information.

9. **Prospective application** of a change in accounting policy and of recognising the effect of a change in an accounting estimate, respectively, are:
   (a) applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed; and
   (b) recognising the effect of the change in the accounting estimate in the current and future periods affected by the change.

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ACCOUNTING POLICIES

Selection and Application of Accounting Policies

When an Ind AS specifically applies to a transaction, other event or condition, the accounting policy or policies applied to that item shall be determined by applying the Ind AS.

As per Ind AS 8, if any of the Ind AS already specifies the guidelines about following a particular policy then entity **must** follow that standard and apply the policy as per the guidance provided. Moreover, an entity can also refer to guidance notes which are published by ICAI, along with the relevant Ind AS, if there is an ambiguity or there is need to go into the depth of a particular transaction.

(A)

How to select and apply an accounting policy when specific Ind AS is not available on the particular transaction/condition/event?

- In the absence of an Ind AS 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.

- In making the judgement, management shall refer to, and consider the applicability of, the following sources in descending order:
  (a) the requirements in Ind AS 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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- Management may also first consider the most recent pronouncements of International Accounting Standards Board (IASB) and in absence thereof those of the 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.

Consistency of accounting policies

An entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions, unless an Ind AS specifically requires or permits categorisation of items for which different policies may be appropriate. If an Ind AS requires or permits such categorisation, an appropriate accounting policy shall be selected and applied consistently to each category.

Changes in Accounting Policies

- An entity shall change an accounting policy only if the change:
  (a) is required by an Ind AS; or
  (b) Results in the financial statements providing **reliable and more relevant information about the effects of transactions**, other events or conditions on the entity's financial position, financial performance or cash flows.

- **The following are not changes in accounting policies:**
  (a) the application of an accounting policy for transactions, other events or conditions that differ in substance from those previously occurring; and
  (b) The application of a new accounting policy for transactions, other events or conditions that did not occur previously or were immaterial.

How to apply the Changes in Accounting Policies?

While discussing the process for application of changes of accounting policies, Ind AS 8, bifurcates it into two situations.

1. an entity shall account for a change in accounting policy resulting from the initial application of an Ind AS in accordance with the specific transitional provisions, if any, in that Ind AS:

   If change in accounting policy is due to new Ind AS, then generally the standard itself **will provide the transitional period** for implementation. The guidelines will also be provided how it needs to be done in a phased manner. In such cases the company need to follow the guidelines and implement the provisions accordingly.

2. when an entity changes an accounting policy upon initial application of an Ind AS that does not include specific transitional provisions applying to that change, or changes an accounting policy voluntarily, **it shall apply the change retrospectively**:
   If the change in accounting policy is made voluntarily or where the Ind AS is not clearly setting up any guidelines clearly for transitional period, then the accounting policy need to be applied retrospectively.

Note: Early application of an Ind AS is not a voluntary change in accounting policy.

RETROSPECTIVE APPLICATION

When a change in accounting policy is applied retrospectively, 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.

Analysis

The word retrospective application is defined in Ind AS 8 as applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied.

CHANGES IN ACCOUNTING ESTIMATES

Meaning

- 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 judgements based on the latest available, reliable information. For example, estimates may be required of:
  - bad debts;
  - inventory obsolescence;
  - the fair value of financial assets or financial liabilities;
  - the useful lives of, or expected pattern of consumption of the future economic benefits embodied in, depreciable assets; and
  - warranty obligations.
- The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

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Can estimates be related to prior periods?

The word estimate itself denotes that it is related to future. It cannot be related to past. Therefore, by its nature, the revision of an estimate does not relate to prior periods and is not the correction of an error.

Change in the base of measurement – Whether a change in accounting policy or change in estimate?

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.

Accounting Treatment for a change in the estimates

The effect of change in an accounting estimate, shall be recognised prospectively by including it in profit or loss in:

(a) the period of the change, if the change affects that period only; or

(b) the period of the change and future periods, if the change affects both.

Example

A change in the estimate of the amount of bad debts affects only the current period's profit or loss and therefore is recognised in the current period. However, a change in the estimated useful life of, or the expected pattern of consumption of the future economic benefits embodied in, a depreciable asset affects depreciation expense for the current period and for each future period during the asset's remaining useful life. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods is recognised as income or expense in those future periods.

Example

A new retail entity provides for warranty obligation 2% of its sales. After being in trade for 3 years because of its stringent quality control processes, the actual warranty obligations is at 1%. It has now revised and provides for warranty obligations @ 1%. It is a change in accounting estimate.

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Example

1. A change in the estimate of the amount of bad debts affects only the current period's profit or loss and therefore is recognised in the current period.
2. A change in the estimated useful life of, or the expected pattern of consumption of the future economic benefits embodied in a depreciable asset affects depreciation expense for the current period and for each future period during the asset's remaining useful life.

In both the aforesaid examples, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods is recognised as income or expense in those future periods.

Example

An entity changed in 2X12 its accounting policy with respect to valuation of its inventory from FIFO to weighted average cost formula. This being a voluntary change, it has to be applied retrospectively. The entity had commenced operation in 2X06. The records of all years are available except for 2X09 when due to floods, the same were washed away. It is not possible to recreate the records. It is therefore, impracticable to determine the period- specific impact for 2X09. The entity will apply the change in accounting policy from 2X10.

Example

An entity changed in 2X12 its accounting policy with respect to valuation of its inventory from FIFO to weighted average cost formula. This being a voluntary change, it has to be applied retrospectively. The entity had commenced operation in 2X06. No records of earlier years are available as a virus attack on server in 2X12 had wiped off all past records. It is not possible to recreate the records. It is therefore impracticable to determine the cumulative effect of change. The entity will apply the change in accounting policy from 2X12 only.

Disclosure of changes in estimates

- 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.
- If the amount of the effect in future periods is not disclosed because estimating it is impracticable, an entity shall disclose that fact.

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Thus to summarise the above mentioned provisions, the company should give

i. Effect of change in estimate on the current period

ii. If practicable, then effect of change in estimate on the future period

iii. If impracticable, then the fact need to be stated clearly, that it is impracticable to do so.

ERRORS

Meaning and Types

As per the definition **given in Ind AS 8, 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 approved 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.

Types of Errors

(i) **Mathematical Mistakes:** In accounting terms, generally the errors are called as error of commission. Errors of wrong calculations, carry forward of wrong balances, wrong grouping and regrouping of expenses can be few examples of mathematical errors.

(ii) **Mistakes in applying policies:** Specific standards and guidelines provide the directions for applying specific policies for particular nature of transaction. For example, general principle says that the amounts need to be presented on gross basis, unless otherwise specifically mentioned. Netting of amounts is not permitted without specific mention. If company has net out the amount of discount allowed and discount received, then it will an error while applying the policies.

(iii) **Misinterpretations of facts:** Ind AS 10, talks about the events after reporting period. Whether the event is adjustable event or non-adjustable event depends on whether there exists an evidence or whether the situation was indicative of probable event. This is based on judgement of the management and may result into misinterpretation of facts, if not dealt with properly.

(iv) **Omissions:** The mistakes that happened due to either partial or complete omission of the transaction.

(v) **Failure to use reliable information:** Assume that the new accounting standard is issued by the Institute, which is applicable to the company from the current financial year. If company fails to apply that standard, without any valid reason and also does not disclose the fact that it is not being applied, it will be treated as failure to us the reliable information.

All the above mentioned errors may happen while recognising the transaction, or while measuring the transaction, or while presenting it in financial statements or it might be possible that proper disclosure is not done.

Example

The following arithmetical error occurred in preparation of A Limited financial statement of immediately preceding financial year – (a) Depreciation on plant and machinery understated by an amount equal to 0.30% of sales; (b) Warranty provisions understated by an amount equal to 0.15% of sales; (c) Allowance for bad debts understated by an amount of 0.25% of sales. Individually none of these errors may be material but could collectively influence the economic decision of the users of the financial statements. These are material prior period errors.

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Treatment of Errors

Financial statements do not comply with Ind AS if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows.

(A) Potential Errors of Current Period

Potential current period errors discovered in that period are corrected before the financial statements are approved for issue.

(B) Prior period errors, discovered subsequently

However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period.

Situation 1: Error was discovered in the earliest prior period presented:

An entity shall correct material prior period errors retrospectively in the first set of financial statements approved for issue after their discovery by restating the comparative amounts for the prior period(s) presented in which the error occurred;

Example

While preparing the financial statement for the F.Y. 20X2-20X3, the latest prior period presented would be F.Y. 20X1-20X2. If the mistake is discovered for the year 20X1-20X2, then it will be rectified, immediately while presenting the statements for the year 20X2-20X3.

Situation 2: Error was discovered before earliest prior period presented:

If the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.

Example

While preparing the financial statements for the F.Y. 20X4-20X5, if the mistake has been discovered for the year 20X1-20X2, i.e. for the period which was earlier than the latest prior period presented, then the corrected opening balances as on 1st April 20X3 of equities, assets and liabilities will be restated.

Example

A material error in creation of a depreciation provision of the preceding year ended March 31, 20X2 was discovered when preparing the financial statements for March 31, 20X3. The amount recognised in statement of profit and loss of March 31, 20X2 was Rs 1,00,000 instead of Rs 50,000 In this case, when presenting the financial statements of March 31, 20X3, figures for March 31, 20X2 will be restated at Rs 50,000 instead of Rs 1,00,000.

Example

Continuing with the aforesaid example, assume the error related to March 31, 20X1 and March 31, 20X1 is not the earliest period for which comparative information is presented. In this case, the figures of retained earnings in statement of changes in equity will be restated.

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DISCLOSURE OF PRIOR PERIOD ERRORS

An entity shall disclose the following:

(a) **The nature** of the prior period error;

(b) If practicable, the **amount of correction** for each prior period presented, item by item and also its impact on EPS.

(c) The amount of the correction made in opening balances of comparative period.

(d) If retrospective restatement is impracticable, the circumstances that led to impracticability and the existence of that condition and the details about how and from when the error has been corrected.

Financial statements of subsequent periods need not repeat these disclosures.

Q445. (ICAI)

An entity starts a business in July 2X05. The business was small in nature and therefore the entity did not follow any specific accounting standards for valuation of inventory. Over the decade the entity flourishes, becomes a big company and decided to apply Ind AS 2 on inventories from the financial year 2X16-2X17. It decided to follow the weighted average method for valuation of inventory. Now following questions will arise.

i. Shall entity do such valuation retrospectively or prospectively?

ii. What is meant by retrospective application?

iii. If it is to be applied as if it was applied from July 2X05, then what about the accounts already presented? Does entity need to change all the accounts?

iv. How would the effect be given?

Solution

(i) It will depend upon whether the company is following the standard as per the new guidelines of Institute or is it applying voluntarily? In the above case, the entity itself is taking the decision to apply the standard and therefore it will be treated as **voluntary application.** If it falls under voluntary application then, the Ind AS 8 states that the policy should be applied retrospectively.

(ii) As per definition, retrospective application assumes that the policy had always been applied. It does not state any specific period. 'Had always been applied' indicates that policy was applied right from the day 1, i.e. from July 2X05.

(iii) The entity is not supposed to change the accounts which are already presented. However, it needs to give the effect of the change in policy while presenting the accounts for the year in which new policy is adopted. In the current case, the new policy is adopted from the F.Y. 2X16-2X17. Therefore, the effect will be given to the concerned items, in the financial statements of F.Y. 2X16-2X17.

(iv) Ind AS 8 states that 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.

When an entity applies a new accounting policy retrospectively, it applies the new accounting policy to comparative information for prior periods as far back **as is practicable.**

Retrospective application to a prior period is not practicable unless it is practicable to determine the cumulative effect on the amounts in both the opening and closing balance sheets for that period.

The amount of the resulting adjustment relating to periods before those presented in the financial statements is made to the opening balance of each affected component of equity of the earliest prior period presented. Usually the adjustment is made to retained earnings. However, the adjustment may be made to another component of equity to comply with an Ind AS.

Any other information about prior periods, such as historical summaries of financial data, is also adjusted as far back as is practicable.

Q446. (ICAI)

Continuing the above illustration, assume that company might be following the weighted average method of valuation of stock right from July 2X05. In reality, company might have applied other methods like specific identification, LIFO or FIFO etc. Company might have changed also the method during the period as it was not following any specific standard at that time. However, now, in F.Y. 2X16-2X17, the company decided to follow Ind AS and accordingly decides the weighted average method of valuation. Analyse

Solution

The company needs to calculate the closing inventory of every year since 2X05-2X06 assuming that it was following the said method from day 1.

This will change the figure of gross profit and net profit as inventory valuation will make direct impact on the profits of the company. Net profits will affect the equity as well. Similarly, the closing balances of inventory from year to year will also change. Thus, company will make the calculations from the year 2X05-2X06 to 2X15-2X16.

The provisions further state that company will adjust the opening balances of equity and other related amounts for the **earliest prior period presented.** It means, if company is presenting the accounts for F.Y. 2X16-2X17, it need to give comparative figures for F.Y. 2X15-2X16 also. Therefore, the **earliest prior period presented** will be F.Y. 2X15-2X16 in the above mentioned case. Thus the net effect on profit of last 11 years (from F.Y. 2X05-2X06 to F.Y. 2X15-2X16) will be adjusted through the equity and inventory balances of the year 2X15-2X16.

Thereafter the new policy will be continued and every year the valuation of inventory will be done using weighted average method.

Q447. (ICAI)

During 20X2, Beta Ltd. discovered that some products that had been sold during 20X1 were incorrectly included in inventory at March 31, 20X1 at Rs 6,500.

Beta's accounting records for 20X2 show sales of Rs 1,04,000, cost of goods sold of Rs 86,500 (including Rs 6,500 for the error in opening inventory), and income taxes of Rs 5,250.

In 20X1, Beta Ltd. reported:

- Sales of Rs 73,500
- Cost of goods sold of Rs 53,500
- Profit before income taxes of Rs 20,000
- Income taxes of Rs 6,000
- Profit of Rs 14,000

20X1 opening retained earnings was Rs 20,000 and closing retained earnings was Rs 34,000. Beta's income tax rate was 30 per cent for 20X2 and 20X1. It had no other income or expenses. Beta Ltd. had Rs 5,000 of share capital throughout, and no other components of equity except for retained earnings. Its shares are not publicly traded and it does not disclose earnings per share.

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Solution

You are required to prepare relevant extract from the statement of profit and loss and statement of changes in equity. Also what should be disclosed in the notes.

Beta Ltd.

Extract from the statement of profit and loss

(Amount in Rs)

	20X2	Related 20X1
Sale	1,04,000	73,500
Cost of goods sold	80,000	60,000
Profit before income taxes	24,000	13,500
Income taxes	7,200	4,050
Profit	16,800	9,450

Beta Ltd.

Statement of changes in equity

(Amount in Rs)

	Share Capital	Retained Earnings	Total
Balance as at March31, 20X0	5,000	20,000	25,000
Profit for the year ended March 31, 20X1 as restated	-	9,450	9,450
Balance as at March 31, 20X2	5,000	29,450	34,450
Profit for the ended March 31, 20x2	-	16,800	16,800
Balance as at March 31, 20X2	5000	46,250	51,250

Extract from the notes:

Some products that had been sold in 20X0-20X1 were incorrectly included in inventory at March 31, 20X1 at Rs 6,500. The financial statements of March 31, 20X1 have been restated to correct this error. The effect of the restatement on those financial statements is as summarised above. There is no effect in March 31, 20X2.

Student Notes:-

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Student Notes:-

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