International Accounting Standards - The Key Issues in IAS 8 and 10

Robert Kirk examines the key issues in IAS 8 and IAS 10 in this fourth article of his series on international accounting standards.

IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

The objective of IAS 8 is to prescribe the criteria for selecting and changing accounting policies together with the disclosure and accounting treatment of changes in a reporting entity's accounting policies, accounting estimates and corrections of errors.

The definitions in the standard are simpler than provided in FRS 18 Accounting Policies (the UK/Irish equivalent). The key definitions are:

Accounting Policies

The specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

Change in Accounting estimate

An adjustment to the carrying amount of an asset/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. They are not errors as they are caused by new information or developments.

Prior Period Errors

Omissions or misstatements for one or more prior periods due to a failure to use or a misuse of reliable information that;

* was available when financial statements for those periods were authorised; and
* could have reasonably be obtained and taken into account when preparing and presenting those financial statements.

This includes mathematical mistakes, mistakes in applying policies, oversights and fraud.

The definition of prior period errors is much broader than the definition provided in FRS 3 Reporting Financial Performance of a fundamental error. There is a real danger that companies may use the new definition to bypass the income statement by charging material 'bad news' to reserves and blaming it on prior years, thus boosting current years' performance.

Selection and Application of Accounting policies

Reporting entities should apply the most appropriate standard if it applies specifically to a transaction. In the absence of an IFRS, management must use their own judgement in developing and applying an accounting policy that results in information that is;

* relevant to the economic decision making needs of users; and
* reliable as it purports faithfully the financial statements, reflects their substance, is neutral, prudent and complete in all material respects.

Management must consider the IFRS/IASs initially and then, if necessary, apply the principles in the Framework for the Preparation and Presentation of Financial Statements in deciding the most appropriate policies. They are also encouraged to look to other standard setters having the same framework, accounting literature and accepted industry practice in making their choice.

Consistency of Accounting policies

Entities must adopt consistent accounting policies for similar transactions unless an IFRS/IAS requires a more specific policy to be adopted.

Changes in Accounting Policies

Entities are only allowed to change an accounting policy if;

* it is required by an IFRS or IAS; or,
* it results in financial statements providing more reliable and relevant information about the effects of transactions on the entity's financial position, performance or cash flows.

However, the following are not classified as changes in accounting policies:

* the application of accounting policies for transactions that differ in substance from those previously undertaken; and,
* the application of a new policy that did not occur previously or was immaterial.

When a new policy is implemented, the opening reserves should be adjusted for the earliest prior period presented as if the new policy had always been applied (retrospective application).

If retrospective application is impractical to prior periods, the entity should apply the new policy to the carrying amounts of assets and liabilities as at the start of the earliest period for which retrospective application is possible. That may well be the current period.

Disclosure

An entity should disclose the following (unless it is impracticable to determine the amount of the adjustment) on a change of accounting policy;

* the title of the standard;
* that the change in policy is made in accordance with any transitional provisions (if applicable);.
* the nature of the change in accounting policy;
* a description of the transitional provisions, if applicable;
* the transitional provisions if they have an effect on future periods, if applicable;
* for current and prior periods, the amount of the adjustment for each item effected as well as its impact on EPS;
* for periods prior to those presented, the impact, if practicable; and,
* if retrospective application is impracticable, the circumstances causing that condition and how the change in policy has been applied.

This disclosure is very similar to FRS 18. When an entity has not applied a new IFRS that is published but not effective, the entity should disclose that fact and try and estimate the possible impact that its application will have on its financial statements.

Changes in Accounting Estimates

Many items in financial statements cannot be measured with precision and must be estimated. These involve judgements based on the latest available information. Examples where this would be applied include bad debts, inventory obsolescence, useful lives, warranty obligations etc.

Estimates need to be revised if circumstances change as a result of new information or experience. A change in measurement base is, however, a change in policy. If it is difficult to distinguish between a policy and an estimate change, the change should be treated as a change in estimate. That is a similar rule to FRS 18.

A change in estimate is charged prospectively in the income statement in the current and future years. Any related asset/liability should equally be adjusted in the period of change.

Disclosure

The nature and amount of a change in accounting estimate and its effect on both current and future periods should be disclosed unless the amount is impracticable to estimate. If the amount of the effect on future years is not disclosed, due to impracticality, that fact must be disclosed.

Errors

Material prior period errors should be corrected retrospectively as soon as discovered by;

* restating the comparatives for the prior periods presented; or
* if the error occurred before the earliest period presented, by adjusting the opening balances of assets, liabilities and equity for the earliest period presented.

An error should be corrected retrospectively unless that is impracticable. If that is the case then the entity must restate the opening balances of assets, liabilities and equity for the earliest period for which retrospective restatement is practicable. If it is impracticable to determine the cumulative impact for all prior periods then the entity shall restate the comparative information to correct the error prospectively from the earliest date practicable. The correction of prior period errors are not included in arriving at the profit or loss for the year.

Disclosure of Prior period Errors

The following should be disclosed:

* The nature of the prior period error.
* For each prior period presented, to the extent practicable, the amount of the correction for each line item affected and for EPS.
* The amount of the correction at the start of the earliest period presented.
* If retrospective application is impracticable, the circumstances that led to the existence of that condition and a description of how and from when the error has been corrected.

This is only required in the year of discovery. It is not required in future years.

IAS 10 Events After The Balance Sheet Date (December 2003)

IAS 10 has just been implemented into Irish Gaap with the publication of FRS 21 with the same title. It is the first of the international standards to be converged with UK/Irish accounting standards. As part of the ASB's convergence project, IAS 10 has been issued as FRS 21 to replace SSAP 17 Accounting for Post Balance Sheet Events. The main change is the removal of dividends declared after the balance sheet date, as adjusting events. Instead they should be disclosed in the notes. They do not meet the definition of a liability under IAS 37 Provisions, Contingent Liabilities and Contingent Assets. Similarly dividends receivable from associates/subsidiaries, relating to a period prior to the balance sheet date, are now classified as non-adjusting.

There is also no exceptional provision in IAS 10 to use prudence to reclassify a non -adjusting event as adjusting.

Objective

The objective of IAS 10 (FRS 21) is:

* To prescribe when an entity should adjust its financial statements for events after the balance sheet date i.e. adjusting events, and
* To prescribe the disclosures about the date of authorisation of the financial statements for both adjusting and non adjusting events and for non adjusting events themselves.

IAS 10 also includes a requirement that an entity should not prepare its financial statements on a going concern basis if events after the balance sheet date indicate that it is no longer appropriate.

Definitions

The following are the key definitions in the standard:

Events after the balance sheet date

These occur between the balance sheet date and the date the financial statements are authorised for issue. There are two types:

* Those providing evidence of conditions existing at the balance sheet date (adjusting).
* Those that are indicative of conditions arising after the balance sheet date (non-adjusting).

These definitions are very similar to SSAP 17 and thus their practical impact is minimal. The standard does, however, provide additional guidance as to the extent of the post balance sheet period. It should finish at the date of authorisation. The standard provides two examples to illustrate the appropriate date:

Example 1

Completion of draft financial statements	28 February 20X2
Board reviews and authorises for issue	*18 March 20X2
Profit announcement	19 March 20X2
Available to shareholders	1 April 20X2
AGM	15 May 20X2
Filed with regulatory body	17 May 20X2

**Correct date of authorisation for issue*

*Example 2**

Management reviews and authorises for issue	*18 March 20X2
Supervisory Board approves	26 March 20X2
Available to shareholders	1 April 20X2
AGM	15 May 20X2
Filed with regulatory body	17 May 20X2

**Correct date of authorisation for issue*

Recognition and Measurement

Adjusting events after the balance sheet date

A reporting entity should adjust the amounts recognised in its financial statements to reflect adjusting events after the balance sheet date. The examples provided are very similar to those provided in SSAP 17 and include the following:

* the settlement after the balance sheet date of a court case confirming a liability;
* the receipt of information after the balance sheet date indicating that an asset was impaired at the balance sheet date e.g. the bankruptcy of a customer, the sale of inventories at a price lower than cost;

* the determination, after the balance sheet date, of the cost of assets purchased or proceeds sold before the balance sheet date;

* the determination after the balance sheet date of the amount of profit/bonus payments provided there was a legal or constructive obligation at the balance sheet date; and,

* the discovery of fraud or error.

Non-Adjusting Events After the Balance Sheet Date

An entity should not adjust the amounts recognised in the financial statements to reflect non-adjusting events after the balance sheet date.

Both IAS 8 and IAS 10 are very similar to the existing UK/Irish financial reporting standards and when implemented will not pose Irish companies with particular problems.

Examples include:

* A major business combination/disposal after the balance sheet date.

* An announcement of a plan to discontinue an operation or entering into binding agreements to sell.

* Major purchases/disposals of assets or expropriations of major assets by government.

* The destruction of a major production plant by fire.

* The announcement or commencing of a major restructuring.

* Major ordinary share and potential share transactions.

* Abnormal large changes in asset prices or foreign exchange rates.

* Changes in tax rates/laws enacted or announced after the balance sheet date.

* Entering into significant commitments e.g. guarantees.

* Commencement of major litigation arising solely out of events that have occurred after the balance sheet date.

Dividends

If dividends are declared after the balance sheet date, no liability should be recognised at that date. Instead they should be disclosed in the notes as a contingent liability. It is argued that they do not meet the definition of a liability under IAS 37. This section of the standard represents the major change in financial reporting that will impact on Irish companies. It is still not clear however, from the standard, whether or not dividends declared before the year end could still be provided although I think that the intent of IAS 10 is not to permit these provisions either.

Going Concern

A reporting entity cannot prepare its financial statements under the going concern basis if the management intends to liquidate the business after the balance sheet date or to cease trading or has no realistic alternative to do so. IAS 1 outlines the required disclosure in such cases.

Disclosure

Date of Authorisation of Issue

The date and who gave the authorisation should be disclosed. Also an additional requirement has been introduced to disclose the fact if the owners or others have powers to amend the financial statements after that date.

Updating Disclosure about Conditions at the Balance Sheet Date

If an entity receives information after the balance sheet date about conditions at the balance sheet date, the entity should update disclosures that relate to these conditions, in the light of any new information. An example might be a contingent liability becoming a provision, then the disclosures re contingent liabilities need to be updated (as per IAS 37).

Non-Adjusting Events After the Balance Sheet Date

If material, these could influence user decisions. Thus the following should be disclosed;

* the nature of the event; and,

* an estimate of its financial effect or a statement that such an estimate cannot be made.

Conclusion

Both IAS 8 and IAS 10 are very similar to the existing UK/Irish financial reporting standards and when implemented will not pose Irish companies with particular problems. The most significant changes are the switch, in IAS 8 from fundamental to material errors as prior year adjustments. That will probably create more opportunities for creative accounting by reintroducing reserve accounting and the ability of companies to bypass the income statement. The main change in IAS 10 is clearly the switch of proposed dividends from current liabilities to mere contingent liabilities. In the next article I propose to look at two further standards – IFRS 5 Non Current Assets Held For Sale and the Presentation of Discontinued Operations and IAS 24 Segment Reporting.

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