

Accounting Changes — Background Information and Basis for Conclusions

Section 1506

Foreword

The pre-changeover standards in Part V of the CPA Canada Handbook – Accounting, which included this Basis for Conclusions document, have been removed from the Handbook. This Basis for Conclusions was developed to accompany the pre-changeover standard, but that standard was not fully converged with Part II of the Handbook. The significant difference is that Section 1506 in Part II of the Handbook permits an enterprise to change its accounting policy choices listed in paragraph 1506.09 without meeting the criterion in paragraph 1506.06 of providing more relevant or reliable information.

Background Information and Basis for Conclusions documents are primary sources of GAAP, as described in GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100. These documents are intended to help readers understand how the AcSB reached its conclusions, but they do not include explanations of the requirements or guidance on the application of the relevant Section or Accounting Guideline.

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TABLE OF CONTENTS	Paragraph
Introduction	1-2
Background	3-9
Basic principles	10-26
Changes in accounting policies	12-16
Accounting for a change in accounting policy	17-20
Changes in accounting estimates	21-22
Errors	23-25
Prospective application	26
Disclosure	27-30
Accounting policies	27
Estimates	28-29
Errors	30
Differential reporting	31
Reporting by not-for-profit organizations	32
Effective date and transitional provisions	33
Consistency with US and international requirements	34-35
Table of concordance	

INTRODUCTION

- 1 This document summarizes considerations that were deemed significant by members of the Accounting Standards Board (AcSB) in reaching the conclusions in the revised ACCOUNTING CHANGES, Section 1506. It sets out the reasons the AcSB undertook the project to develop this material, the process of research and deliberation, the key decisions made, and the principal reasons for adopting the positions taken and rejecting others. Individual AcSB members gave greater weight to some factors than to others.

- 2 Nothing in this document is to be taken as overriding the requirements of the CICA Handbook – Accounting. However, it may help readers understand how the AcSB reached its conclusions in developing the revised Section and the AcSB's intent with respect to its interpretation and application.

BACKGROUND

- 3 In January 2003, the AcSB commenced an Accounting Standards Improvements Project. The purpose of this project is to amend and improve certain parts of the Handbook that are no longer relevant, are incomplete, contain unjustified inconsistencies with US Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) standards, or that warrant reconsideration due to style, lack of specificity, or ineffectiveness. The AcSB identified Section 1506 as one of the Sections that should be improved as part of this project.
- 4 In September 2003, the AcSB issued an Exposure Draft proposing amendments to Section 1506 that would have converged the Section with equivalent amendments to US GAAP and International Financial Reporting Standards (IFRSs). The Exposure Draft was predominately based on International Financial Reporting Standard IAS 8, "Accounting Policies, Changes in Accounting Estimates and Errors."
- 5 In 2004, the AcSB embarked on a process to develop a new Strategic Plan. The AcSB concluded that it was timely to reconsider its previous strategies in light of significant recent developments in the financial reporting environment. After significant public consultation and deliberation, the AcSB approved the new strategic directions in January 2006. For public companies, the objective is to converge with IFRSs over a transitional period. For non-publicly accountable enterprises, the AcSB is undertaking a comprehensive examination of their financial reporting needs and will determine the most appropriate model for meeting those needs. The AcSB will continue to apply the existing system of differential reporting while this examination is being performed. The AcSB's strategies are more fully described in its published Strategic Plan.
- 6 In response to the above-noted strategy, the text of the revised Section 1506 is based on the relevant parts of IAS 8. However, certain paragraphs of IAS 8 have not been adopted. In particular, the AcSB has recently addressed selection of accounting policies in GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100. The AcSB did not believe that the portions of IAS 8 related to aspects of financial reporting addressed in Section 1100 should be adopted at this time, for reasons of cohesion within the CICA Handbook – Accounting.
- 7 The AcSB decided to complete this project at this time due to:
- (a) the financial reporting benefits derived from the improvements; and
 - (b) the fact that both the IASB and FASB have amended their related standards.
- 8 The FASB and the IASB have worked together, as part of their joint short-term convergence project, to amend and improve their requirements for changes in accounting policies, changes in estimates, and errors so that they are converged. In many instances, the amended FASB and IASB standards are converged with Section 1506. However, in other instances, the converged FASB / IASB standards differ from Section 1506.
- 9 In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154, "Accounting Changes and Error Corrections" (FAS 154) (a replacement of APB Opinion No. 20, "Accounting Changes"), and Statement of Financial Accounting Standards No. 3, "Reporting Accounting Changes in Interim Financial Statements" (FAS 3). As noted above, the FASB issued FAS 154 as a result of working with the IASB. Although convergence was an important objective of FAS 154, it differs in some areas from IAS 8. For example, FAS 154 and IAS 8 both require restatement to correct an error that exists in previously issued financial statements; however, IAS 8 permits an exception to this requirement if restatement is impractical, whereas FAS 154 does not.

BASIC PRINCIPLES

- 10 Changes in accounting policies, changes in estimates, and errors may significantly affect the presentation of financial statements for an accounting period, the trends shown in comparative financial statements, and historical summaries. Accordingly, users of financial statements require information to understand the effects of such events on the financial statements.
- 11 In particular, changes in accounting policies, changes in estimates, and errors affect comparability. In this regard, FINANCIAL STATEMENT CONCEPTS, paragraph 1000.23, states:
- "Comparability in the financial statements of an entity is enhanced when the same accounting policies are used consistently from period to period. Consistency helps prevent misconceptions that might result from the application of different accounting policies in different periods. When a change in accounting policy is deemed to be appropriate, disclosure of the effects of the change may be necessary to maintain comparability."

Changes in accounting policies

- 12 Two basic principles underlie the treatment of changes in accounting policies in Section 1506:
- (a) a change in accounting policy should be made only if it results in a reliable and more relevant presentation in the financial statements; and
 - (b) a change in accounting policy should be applied retrospectively 1 to transactions, other events and circumstances as if that policy had always been in use.

- 13 Former Section 1506 referred to a change in accounting policy resulting in a more appropriate presentation of events or transactions, but did not provide criteria on which to base such a judgment. Relevance and reliability are fundamental attributes of information provided in financial statements that make that information useful to users. Information is likely to be more useful if it is more relevant and, at the same time, remains reliable. Therefore, the AcSB concluded that a change in accounting policy should only be permitted when it results in a reliable and more relevant presentation.
- 14 When the AcSB develops a new primary source of GAAP, it takes into account the fundamental attributes of financial information. Accordingly, a change in accounting policy required by a primary source of GAAP satisfies the requirement for a reliable and more relevant presentation.
- 15 Former Section 1506 explicitly mentioned a change in accounting policy as a result of a change in legislative requirements. In accordance with GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100, legislative requirements need to be assessed in the same manner as any other accounting policy. Accordingly, the AcSB concluded that there is no need for the standard to make specific reference to such a change, since it should be assessed in terms of its reliability and relevance in the same manner as any other change in accounting policy. This is consistent with US GAAP and IFRSs.
- 16 Several respondents to the Exposure Draft argued for retaining the statement found in former paragraph 1506.05 that a change in classification as a result of grouping or allocation is not in itself a change in accounting policy. The AcSB agreed with this view, noting that the definition of a change in accounting policy does not necessarily encompass a change in presentation related to grouping or allocation. However, the AcSB did not include former paragraph 1506.05 in the revised Section in order to conform the wording of the Section as closely as possible to that of IAS 8. The AcSB noted that former paragraph 1506.05 was generally consistent with the corresponding requirements of International Financial Reporting Standard IAS 1, "Presentation of Financial Statements," and on that basis decided to carry forward the paragraph by inserting it into GENERAL STANDARDS OF FINANCIAL REPORTING PRESENTATION, Section 1400.

Accounting for a change in accounting policy

- 17 The ideal situation is that a change in accounting policy would always be applied retrospectively. However, there may be circumstances in which this is impractical. Often the AcSB will become aware of such circumstances and take them into account by establishing specific transitional provisions in a standard.
- 18 Section 1506 specifies what considerations must be taken into account to determine whether retrospective application is impractical. These considerations replace the existing Section 1506 requirement to consider whether information for full retrospective application is "reasonably determinable".
- 19 When full retrospective application is impractical, the effects of a change may be applied to only some comparative information or to none at all, depending on the periods for which it is practical to obtain information. Several respondents noted that the Exposure Draft was unclear with respect to partial retrospective application. The AcSB believes that paragraph 1506.24, which is based on IAS 8, is clear with respect to partial retrospective application.
- 20 The AcSB considered the application of the Exposure Draft proposals to the adoption of a new accounting policy based on a source of GAAP other than a primary source. The AcSB concluded that in those circumstances, it is appropriate that the basic principle of retrospective application apply. The IASB reached a similar conclusion. If an "other source of GAAP" contains transitional provisions, they are unlikely to have been developed within the context of primary sources of GAAP, or to be applicable other than to making a change in accordance with the context in which those other sources may have been developed.

Changes in accounting estimates

- 21 A change in accounting estimate differs from a change in accounting policy in that it does not affect prior periods. Accordingly, retrospective application is not relevant. In these circumstances, the accounting only affects the period in which the change in estimate is made and, where relevant, subsequent periods. This treatment is consistent with both US GAAP and IFRSs.
- 22 Several respondents to the Exposure Draft requested a definition of a change in accounting estimate. The AcSB concurred with this request. The final standard includes a definition, which is converged with IAS 8.

Errors

- 23 An error may arise as a result of a mistake, oversight, misinterpretation of the facts, or fraud. An error was not explicitly defined in the former Section 1506. The revised standard adopts the definition in IAS 8, which is consistent with the use of that term in former Section 1506 and US GAAP. When an error is discovered, it is most useful to financial statement users to restate prior period financial statements as if the error had never occurred. Accordingly, errors are corrected retrospectively. In these circumstances, the term "restatement" is used, rather than "application", to differentiate circumstances that require prior period information to be corrected from those in which there was nothing wrong with the prior period information as it was presented in the past. In the latter case, an improved method of accounting or presentation has been identified in the current period.
- 24 The AcSB decided that there should be no ability to avoid retrospective restatement for errors on the grounds of impracticability. This is consistent with current US GAAP, but not with IAS 8. Under IAS 8, if restatement is impracticable, the error is corrected by restating information for the earliest period where restatement is practicable.

The AcSB noted that it would be very rare that the impracticability criteria would be met in respect of an error. However, it also noted that it would be inconsistent for an entity to state that its financial statements are prepared in accordance with GAAP when those statements include uncorrected errors.

- 25 As a result of the AcSB's Strategic Plan, the complete version of IAS 8 will be adopted in Canada in the foreseeable future. Therefore, this departure from IAS 8 will be temporary.

Prospective application

- 26 The Exposure Draft did not refer to prospective application. In developing the Exposure Draft, the AcSB decided that it would be better to focus on retrospective application in the Section and explain any other bases of application in specific primary sources of GAAP. The explanation of prospective application in the former Section 1506 proved difficult to interpret in practice, particularly the extent to which it applies to outstanding balances. Several Exposure Draft respondents misinterpreted the proposed removal of the term "prospective" from the Section, believing that prospective application was not permitted under any circumstance. This was not the AcSB's intent. The final standard adopts the IAS 8 definition and use of the term "prospective", but is modified so that it is overridden by definitions of prospective application as stated in other primary sources of GAAP. The AcSB will advise the IASB of the practical issues in interpreting prospective application.

DISCLOSURE

Accounting policies

- 27 The following disclosures about changes in accounting policies are significant new requirements:
- (a) The amount of adjustment relating to periods prior to those presented in comparative information.
 - (b) The justification for a voluntary change in accounting policy. This is required by both US GAAP and IFRSs. The AcSB concluded that the reasons why the new accounting policy results in a more relevant presentation should be provided, to avoid "boilerplate" disclosures.
 - (c) The effects of an issued pronouncement that has not yet been applied. This is required for listed companies in the US by SEC Staff Accounting Bulletin 103, Topic 11M. These disclosures are the same as those required by IAS 8. Several respondents disagreed with requiring these disclosures. Some respondents believed that the wording of the Exposure Draft included disclosures of primary sources of GAAP that are irrelevant to an entity. The AcSB did not intend for irrelevant primary sources of GAAP to be included in these disclosures. The Board noted that the wording of paragraph 30 of the final standard ("When an entity has not applied ...") implies that the primary source of GAAP is relevant to the entity. The AcSB considered whether this disclosure requirement should be applicable to all entities, but concluded that it was unlikely to be unduly onerous for non-public companies or entities qualifying for differential reporting. Some respondents objected to the proposed disclosure requirements, particularly with respect to the requirement to provide an estimate of the effect of the change(s) on an entity's financial position. The AcSB noted that the final standard more closely reflects the wording in IAS 8, requiring "discussion" rather than "an estimate", thereby softening the disclosure requirements proposed in the Exposure Draft. The AcSB also noted that paragraph 1506.31(e)(ii) allows for situations in which the effect of the unadopted primary source of GAAP is not known or reasonably estimable.

Estimates

- 28 In the former Section 1506, disclosures regarding changes in accounting estimates were described as desirable, rather than required. The revised standard makes these disclosures required, consistent with US GAAP and IFRSs. Several Exposure Draft respondents believed that this requirement would cause excessive disclosures due to the significant number of estimates that are required for preparation of financial statements. The AcSB considered whether it was necessary to specify that disclosures about changes in estimates are unnecessary for estimates made in the normal course, but was concerned that would lead to the need to define what constitutes "normal course". It concluded that materiality considerations would take into account such changes in estimates. The AcSB also considered whether disclosures about changes in estimates affecting only the current period should be applicable to some entities and not others, but concluded that they were unlikely to be unduly onerous for non-public companies or entities qualifying for differential reporting, particularly once materiality considerations were taken into account, and therefore decided that the disclosures should be required.
- 29 Consistent with IAS 8, an exception to the provision of disclosure of the effect on future periods is provided on the grounds of impracticability. US GAAP does not allow such an exception.

Errors

- 30 The AcSB noted that under the requirements of former Section 1506, it was often difficult to ascertain from disclosures about corrections of an error that an error had occurred in one or more prior periods. Accordingly, the AcSB has introduced a requirement to disclose the fact that an error has been made.

DIFFERENTIAL REPORTING

- 31 The amendments to Section 1506 have been reviewed by the Differential Reporting Advisory Committee. The Committee recommended a differential reporting option for disclosures of the effects of an issued pronouncement that has not yet

been applied. The AcSB did not agree with the Advisory Committee's assessment of costs and benefits for the reasons noted in paragraph 27(c).

REPORTING BY NOT-FOR-PROFIT ORGANIZATIONS

- 32 The amendments to Section 1506 have been reviewed by the Not-for-Profit Organizations Advisory Committee. The Committee believes the requirements are appropriate for not-for-profit organizations.

EFFECTIVE DATE AND TRANSITIONAL PROVISIONS

- 33 The revised Section 1506 applies to interim and fiscal periods beginning on or after January 1, 2007. This date allows an entity six months from the date the Section is published to implement the new requirements, which the AcSB believes to be sufficient. The AcSB did not believe that any special transitional provisions were necessary for this Section.

CONSISTENCY WITH US AND INTERNATIONAL REQUIREMENTS

- 34 The AcSB believes that the requirements in the revised Section 1506 are not in conflict with US GAAP or IFRSs.
35 In order to assist constituents in understanding the extent to which further change to practice will be required upon conversion to IFRSs, a table of concordance is provided below.

TABLE OF CONCORDANCE

This table shows how the contents of this Section and the current version of IAS 8 correspond. Paragraphs are treated as corresponding if they broadly address the same matter, even though the guidance may differ. Style changes are changes to conform with certain CICA Handbook – Accounting style conventions, for example, the use of "Section" instead of "standard". Terminology changes include changes to remain consistent within the Handbook. Reference changes are instances where cross-references within the Handbook are maintained.

Paragraph	Notes
.01	Style and differing scopes
.02	References
.03	Style
.04	References
.05	Style, terminology and references
.06	Not used
.07	Not used
.08	Not used
.09	Not used
.10	Not used
.11	Not used
.12	Not used
.13	Not used
.14	Style, terminology and references
.15	Style
.16	
.17	Not used
.18	Not used
.19	Style and terminology
.20	Style and terminology
.21	Terminology
.22	Style and references
.23	Style and references
.24	
.25	

.26	Terminology
.27	Style
.28	Style, terminology and references
.29	Style and references
.30	Style and terminology
.31	Terminology
.32	
.33	
.34	
.35	
.36	Style and terminology
.37	
.38	Terminology and difference to allow another primary source of GAAP to provide additional guidance regarding prospective application
.39	
.40	
.41	Terminology
.42	Style
.43	Not used
.44	Not used
.45	Not used
.46	Style and difference to not allow impracticality to extend to errors
.47	Not used
.48	
.49	Style and references; sub-paragraph (d) not used
.50	Style and difference with respect to impracticality and errors
.51	
.52	Difference with respect to impracticality and errors
.53	Style and references
.54	Style and different effective date
.55	Not used
.56	Not used

Footnotes

1. The terms "restrospective" and "retroactive" are intended to have the same meaning in the CICA Handbook – Accounting. Prior to its amendment in July 2006, Section 1506 used the term "retroactive".

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