LKAS 08: Accounting Policies, Changes in Accounting Estimates and Errors

Introduction

The objective of this Standard is to prescribe the criteria for selecting and changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and corrections of errors.

Accounting Policies

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

The following are a few examples for accounting policies

- Apply First-in, first-out (FIFO) or Weighted average cost (WAC) to measure the cost on inventory.
- Apply cost model or revaluation model for the subsequent measurement of property, plant and equipment.

Selection of Accounting Policies
Accounting policies should be selected using the following methods.

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

   For example, *LKAS 2 - Inventory*, specifies either FIFO or Weighted Average Cost method to value the inventories of an entity.

b) In the absence of an accounting standard 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 accounting standards dealing with similar and related issues;

and

b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Conceptual Framework for Financial Reporting (Conceptual Framework).

In making the judgement, management may also consider the most recent pronouncements of 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 above sources.

Changes in Accounting Policies

An entity should select and apply its accounting policies consistently for similar transactions, other events and conditions. However, an entity shall change an accounting policy only if the change:

(a) is required by a accounting standard; 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.

Accounting for changes in Accounting Policies

i. If a policy is changed as a requirement of an accounting standard, an entity should account for the change in accordance with the specific transitional provisions of the relevant standard. Prospective applications is the usual method for this.

   Prospective application
   Prospective application of a change in accounting policy and of recognizing 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) recognizing the effect of the change in the accounting estimate in the current and future periods affected by the change.

ii. If the change is made by an entity voluntarily, it should be applied retrospectively.

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

   If retrospective application is impracticable, the circumstances making it impracticable and the date from which the accounting policy has been applied should be disclosed.

Accounting Estimates

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.

Accounting estimates are monetary amounts in financial statements that are subject to measurement uncertainty.

Examples for accounting estimates:

- Net realizable value of inventory
- Depreciation method
- Useful life and residual value of Property, Plant and Equipment
- Warranty provision
- Fair value
- Goodwill
- Inventory obsolescence
- Impairment loss (Bad debts and doubtful debts)

These accounting estimates may change as the business environment changes or as the management gains more experience.

Changes in Accounting Estimates

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.

Accounting for changes in Accounting Estimates

The effect of a change in an accounting estimate shall be recognized **prospectively** by including it in profit or loss in:

(a) **the period of the change, if the change affects that period only; or**
For example, a change in the estimate of the amount of bad debts affects only the current period's profit or loss and therefore is recognized in the current period.

(b) t**he period of the change and future periods, if the change affects both.**
For example, 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.

Prospective recognition of the effect of a change in an accounting estimate means that the change is applied to transactions, other events and conditions from the date of the change in estimate.

Errors

Errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements. Current period errors discovered in that period are corrected before the financial statements are authorized for issue. 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.

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 authorized 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.

Accounting for the correction of the prior period error

An entity shall correct material prior period errors **retrospectively** in the first set of financial statements authorized for issue after their discovery by:

(a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or
(b) 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.

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.