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Ref: EFRAG's Draft Comment Letter to the IASB's Exposure Draft *Accounting Policies and Accounting Estimates – Proposed amendments to IAS 8*

~~Dear Mr Gauzès,~~ Dear Jean-Paul,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to EFRAG's draft comment letter regarding the IASB's Exposure Draft (ED) *Accounting Policies and Accounting Estimates – Proposed amendments to IAS 8*. We are pleased to provide you with the following comments with the aim of improving the transparency and enforceability of financial statements.

Like EFRAG, ESMA generally agrees with the clarifications on how accounting estimates and accounting policies relate to each other. We believe that these amendments together with the new definition of accounting estimate will provide greater clarity on the majority of the issues raised by ESMA in its 2013 submission to the IFRS IC, although we believe that further improvements can still be made.

Firstly, unlike EFRAG, ESMA believes that the proposed definition of accounting policy could be further enhanced either by explaining how the term 'practices' shall be understood or by deleting it, as there is no commonly accepted notion or definition of 'practices' and, it is not always clear whether any practice shall always be regarded as an accounting policy.

Secondly, like EFRAG, we note that distinguishing between accounting policy and accounting estimate will remain challenging in certain circumstances. This is partly due to the fact that the definitions do not explicitly address how to assess situations in which an issuer makes changes to self-imposed accounting definitions or criteria that are used to implement certain IFRS requirements (for example, when internal thresholds are defined).

In addition, difficulties may also arise from the proposal to accompany the general definitions with a provision that specifically requires that selecting the cost formula when applying IAS 2 *Inventories* constitutes an accounting policy choice. Unlike EFRAG, ESMA is concerned that this approach may lead issuers to apply by analogy these specific requirements in conjunction with the definitions of accounting policy and accounting estimate and reach different conclusions than when applying these definitions in isolation.

Finally, ESMA suggests that the IASB further explains the distinction between the change in estimate and the correction of an error in the basis for conclusions section accompanying the amended paragraph 34 of IAS 8.

Please do not hesitate to contact us should you wish to discuss all or any of our comments.

Yours sincerely,

Steven Maijoor

Appendix I – ESMA's detailed answers to the questions in the ED

Question 1

The Board proposes clarifying the definition of accounting policies by removing the terms 'conventions' and 'rules' and replacing the term 'bases' with the term 'measurement bases' (see paragraph 5 and paragraphs BC5–BC8 of the Basis for Conclusions).

Do you agree with this proposed amendment? Why or why not? If not, what do you propose and why?

1. ESMA agrees with the IASB's proposal to remove the terms 'conventions' and 'rules' and to replace the term 'bases' with 'measurement bases'.
2. However, we are concerned that retaining the use of the term 'practices' may continue to create confusion as it may lead to conclude that *all* practices are accounting policies, whilst ESMA understands that certain practices may constitute an accounting estimate. Furthermore, the term practices could be interpreted as referring to the ex-post and practical implementation of a previously approved accounting policy. Therefore, practices as such are just the outcome of having previously established a set of accounting policies, the implementation of which would lead to certain accounting 'practices'.
3. For example, some may argue that a practice that relates to the assumptions used when implementing a specific policy shall qualify as an accounting estimate, while others may believe that an accounting practice *always* constitutes an accounting policy as the term 'practices' is referred to in the definition of accounting policy.
4. We note that it is not clear whether a certain *practice* of selecting a specific set of assumptions or quantitative threshold shall always qualify as an accounting policy or, depending on the circumstances, it can also qualify as an accounting estimate. In addition, we note that some believe that the term practices only applies to industry-wide established practices, while for others it more generically refers to any entity-specific *habit* in applying IFRS.
5. In order to avoid this confusion, ESMA suggests that either the IASB explains how the term 'practices' shall be intended in the context of the relationship between the definition of accounting policy and the definition of accounting estimate or it is deleted.

Question 2

The Board proposes:

(a) clarifying how accounting policies and accounting estimates relate to each other, by explaining that accounting estimates are used in applying accounting policies; and

(b) adding a definition of accounting estimates and removing the definition of a change in accounting estimate (see paragraph 5 and paragraphs BC9–BC16 of the Basis for Conclusions).

Do you agree with these proposed amendments? Why or why not? If not, what do you propose and why?

6. ESMA supports the proposed clarifications and definition. However, we believe that illustrative examples shall be provided to ease the application of the new and revised definitions and to assist in clarifying how accounting estimates and accounting policies relate to each other.
7. ESMA notes that in its original submission to the IFRS IC[1], the following issues were identified for which the distinction between policies and estimates was unclear:
   a. change in the own credit risk calculation from CDS curves to spread of the most recent debt issuance;
   b. change in definition of the High Quality Corporate Bond;
   c. change of method of credit value adjustment (CVA) calculation, from historical approach to determine the probability of default and the loss given default to market based approach;
   d. change in the measurement formula of the cost of the inventories from first-in-first-out (FIFO) to weighted average cost; and
   e. change in the "significant or prolonged" criteria which trigger impairment for Available for Sale equity instruments
8. We believe that the clarifications provided and the new definition of accounting estimate would lead us to conclude that the situations listed above in (a)-(c) would constitute changes in estimate.
9. However, ESMA notes that the new proposed requirement in paragraph 32B according to which selecting the cost formula when applying IAS 2 *Inventories* constitutes the selection of an accounting policy, may interfere with the application of the proposed definitions and lead to different conclusions as further explained in our response to question 4.
10. ESMA also notes that it remains unclear whether the 'significant or prolonged' criteria for the impairment of available for sale equity instruments under IAS 39[2] constitute an accounting policy or an accounting estimate. On one hand, these criteria operationalise the judgment whether an impairment occurred or not and therefore would qualify as accounting estimates. On the other hand, there is no need to apply any judgments or perform any estimate once certain pre-defined quantitative thresholds have been set and therefore selecting these criteria would qualify as an accounting policy.
11. In addition, ESMA notes that implicit accounting choices, such as setting a specific definition or measurement framework, are not captured in the proposed definition of accounting policy or accounting estimate (e.g. an issuer's own definition of default as per paragraph B5.5.37 of IFRS 9 or an issuer's own choice of the specific measurement framework to perform a liability adequacy test as required by paragraph 15 of IFRS 4 *Insurance Contracts*).
12. The proposed amendments do not bring clarity on whether such choices would qualify as: (i) a change in accounting policy analogising with the proposed paragraph 32B of IAS 8 given that once the definition is set, no judgments or estimate need to be done; or (ii) a

[1] https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-854_esma_letter_to_ias_ic_re_application_of_ias_8.pdf
[2] After 1 January 2018, IAS 39 will remain applicable for those issuers which will qualify for the application of the temporary exemption from the application of IFRS 9 on the basis of the amendments to IFRS 4 *Insurance Contracts* as endorsed in the EU.

change in accounting estimates if the defined item (e.g. credit risk) is subject to estimation uncertainty.

Question 3

The Board proposes clarifying that when an item in the financial statements cannot be measured with precision, selecting an estimation technique or valuation technique constitutes making an accounting estimate to use in applying an accounting policy for that item (see paragraph 32A and paragraph BC18 of the Basis for Conclusions).

Do you agree with this proposed amendment? Why or why not? If not, what do you propose and why?

13. ESMA agrees with the proposed amendment that is in line with existing guidance in IFRS 13, but encourages the IASB to further consider how to clarify the distinction between accounting estimate and error. Our comments in this respect are included in the response to question 5.

Question 4

The Board proposes clarifying that, in applying IAS 2 Inventories, selecting the first-in, first-out (FIFO) cost formula or the weighted average cost formula for interchangeable inventories constitutes selecting an accounting policy (see paragraph 32B and paragraphs BC19–BC20 of the Basis for Conclusions).

Do you agree with this proposed amendment? Why or why not? If not, what do you propose and why?

14. In ESMA's view, specifying that the selection of the cost formula in IAS 2 constitutes the selection of an accounting policy may *de facto* create confusion in distinguishing between policies and estimates. In fact, applying the principles-based definitions and analogising to the specific rule relating to inventories may lead to different conclusions as shown in the examples mentioned in response to the previous question.
15. Consequently, while agreeing with the content of the proposed paragraph, ESMA suggests that the text in the proposed paragraph 32B is included as an example to illustrate the application of the proposed definition of accounting policy.

Question 5

Do you have any other comments on the proposals?

16. ESMA would suggest the IASB to better clarify in paragraph 34 of IAS 8 how accounting estimates and errors differ, also by providing specific examples. ESMA notes that an attribute of accounting estimates as defined in the proposed amendments, is that they relate to items which cannot be measured with precision due to the uncertainties inherent in business activities. ESMA believes that lack of precision in measurement also depends on the nature of the items being accounted for. For example:

a. measurement of cash may be less prone to measurement uncertainty than assessment of expected credit losses; and

b. application of present value techniques and the selection of the assumptions used therein may be refined over time.

17. We believe that it would be important to explain how and whether the nature of the items relate to the assessment of an accounting estimate and to errors. In addition, we believe that the reference to uncertainties in business activities may create additional confusion between accounting errors and estimates.

18. Therefore, ESMA would suggest the IASB to delete the explanation relating to the reasons underlying the lack of precision in measurement and focusing on reinforcing the distinction between estimates and errors, taking into account also the nature of the item. Particularly, ESMA would suggest the IASB to retain as part of the basis for conclusions accompanying the amended paragraph 34 of IAS 8, the deleted explanation in paragraph 5 that: '*Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors*'. In this way, it would be clearer that a change in estimate due to a misuse or a failure to use available reliable information is the correction of an error.

19. ESMA also believes that the IASB should require specific disclosures when it is most difficult to distinguish a change in accounting policy from a change in accounting estimate as provided for in paragraph 35 of IAS 8.

20. Finally, ESMA suggests that the IASB provides examples of the terms judgements and assumptions and that the use of these terms is made consistent across different standards.