

This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG-CFSS. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG-CFSS. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

Exposure Draft ED/2017/5 Accounting Policies and Accounting Estimates (*Amendments to IAS 8*)

Issues Paper

Objective

- 1 To provide an overview of the feedback received by the IASB on ED/2017/5 *Accounting Policies and Accounting Estimates* (the 'ED') and ask members about their views for the next steps in the project.

Background

- 2 On 12 September 2017, the IASB published the ED which proposes to clarify:
 - (a) the definitions of accounting policies and provide a definition of accounting estimates with the objective of making them more concise and distinctive;
 - (b) how accounting policies and estimates relate to each other;
 - (c) that changes in valuation techniques and changes in estimation techniques are changes in accounting estimates; and
 - (d) that a change in the cost formulas of IAS 2 Inventories in determining the cost of interchangeable inventories is a change in accounting policy.
- 3 EFRAG issued its final comment letter on 8 January 2018 which:
 - (a) supported the IASB's initiative to clarify the definition of accounting policies and to provide a definition of accounting estimates but considers that the proposals may not deliver sufficient clarification unless supported by additional illustrative examples;
 - (b) Agreed with the proposed clarification that changes in valuation techniques and changes in estimation techniques are changes in accounting estimates; and
 - (c) Acknowledged the need to address the diversity in practice regarding changes in the cost formulas of interchangeable inventories but recommends that the proposed guidance is placed in IAS 2 Inventories to avoid any application by analogy to other circumstances.
- 4 Lastly, EFRAG recommended that the proposed Amendments are published as a package with other forthcoming amendments to IAS 8 tentatively approved by the IASB on accounting policy changes.

Summary of the feedback received by the IASB

- 5 Overall, the IASB received 82 comment letters. Most respondents agreed that the proposals in the ED would provide more clarity on how accounting policies relate to accounting estimates. However, some (including EFRAG) questioned whether the proposals would result in sufficient improvement. In particular, many respondents state that having more illustrative examples would provide more clarity on the distinction between accounting policies and accounting estimates, which in itself is a conceptual matter.
- 6 Other comments are presented below for each of the questions in the consultation.

Definition of accounting policies

- 7 Many respondents agree with the overall proposals. Some, however, cautioned the IASB to keep the definition at a high conceptual level and avoid using that are undefined and therefore open to differing interpretations. In particular, some suggested that the term 'practice', if not defined, could create confusion with the term 'the terms 'valuation techniques' and 'estimation techniques'.
- 8 Some respondents also disagreed with the addition of 'measurement bases' to the definition of an accounting policy as they considered that the terms 'principle' and 'practice' are already sufficient to capture measurement bases.
- 9 A few respondents noted that neither IAS 8 nor the proposed ED addressed the question as to whether adopting a practical expedient should be regarded as an accounting policy.

Definition of accounting estimates

- 10 Almost all respondents agreed, like EFRAG, with the proposal to replace the definition of a change in accounting estimate with the definition of accounting estimates. Most respondents also agree with the proposed wording of the definition of accounting estimates.
- 11 Some respondents, including EFRAG, were of the view that the IASB should provide more guidance for drawing the distinction between changes in accounting estimates and corrections of error. These respondents considered that it may be difficult to define estimates clearly enough without addressing errors as well.
- 12 A few respondents also:
 - (a) Suggested to remove paragraph 35 of IAS 8 (which states that 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) as the clarifications provided by the ED made this paragraph unnecessary;
 - (b) Noted that the definition identifies accounting estimates as the inputs used in determining an amount; they question whether it would be more appropriate to identify accounting estimates as the outputs of that process (for example, a carrying amount), rather than as the inputs; and
 - (c) Suggested removing the phrase 'because of estimation uncertainty' from the proposed definition of accounting estimates because, although this term is used in IFRS Standards, it is not defined. These respondents considered that it will be sufficient for the definition to retain the phrase 'cannot be measured with precision'.

Estimation techniques and valuation techniques

13 Almost all respondents agreed, like EFRAG, with the proposals.

Cost formulas for interchangeable inventories

14 Most respondents agreed, like EFRAG, that selecting a cost formula constitutes selecting an accounting policy.

15 Regarding the placement of the guidance:

- (a) Some respondents (including EFRAG) considered that the guidance should not be included not in IAS 8, as proposed in the ED, but instead in IAS 2 *Inventories*; as inclusion in IAS 8 could lead to inappropriate analogies being drawn in other circumstances.
- (b) Some respondents saw merit in having this discussion in IAS 8 as proposed in the ED; and
- (c) Others suggested to place the discussion in IAS 8, with cross-references to and from IAS 2.

Transition requirements

16 Some respondents (including EFRAG) considered that it would be useful if the effective date of this amendment is aligned with any other planned amendments to IAS 8 and to issue them as a package. Some also suggested an alignment with the effective date of the proposed amendment to the definition of 'material'.

Adding illustrative examples

17 Many respondents (including EFRAG) considered that adding further illustrative examples of accounting policies and accounting estimates will further improve the distinction between accounting policies and accounting estimates. However, none of the respondents provided examples of illustrative examples.

18 The staff of the IASB has considered this request and will seek ASAF members' advice on whether to provide illustrative examples and in what format.

19 Based on the feedback received, the staff of the IASB tentatively considered that the main area where illustrative examples would be needed is accounting policies. This is because:

- (a) the existing and the proposed amended definition of accounting policies are kept at a very high conceptual level, ie as principles and measurement bases; and
- (b) paragraph 32 of IAS 8 provides several examples of accounting estimates but does not provide any examples of accounting policies.

20 The staff of the IASB also considered that, instead of giving answers to specific situations, the examples should aim at illustrating the thought process for distinguishing accounting policies from accounting estimates and developed one example to illustrate that approach (contained in Appendix 1 to this paper and in paragraph 14 of agenda paper 12-02).

IASB meeting on 21 March 2018

21 The IASB discussed the feedback received at its meeting on 21 March 2018. No decisions were taken at the meeting as to the finalisation of the amendments.

22 Members expressed mixed views on whether the amendments should be finalised as they are (ie whether they brought sufficient improvements) and on the inclusion

of illustrative examples. The IASB will seek input from ASAF at its April meeting and decide on a course of actions afterwards.

EFRAG Secretariat initial views

- 23 In its final comment letter EFRAG considered that the IASB should further clarify the interaction between an accounting estimate and an accounting policy and how the amended definition should be applied in practice by providing additional illustrative examples. Illustrative examples could also help ensure that the proposed amendments are not perceived as narrowing the definition of 'accounting policies' to a greater extent than intended.
- 24 EFRAG also agreed that illustrative examples should not aim at providing guidance on specific fact patterns but rather illustrate how the proposed principles help clarify the distinction between accounting policies and estimates.
- 25 EFRAG suggested that the IASB should, particularly, consider whether and how the amendments along with additional illustrative examples would serve to help to address the examples identified in ESMA's submission to the IFRS Interpretations Committee in 2014 namely:
- (a) change in the own credit risk calculation: a change in the assessment of own credit risk for measurement of financial liabilities at fair value (e.g. from using a credit default swap curve to using the spread of the most recent debt issuance);
 - (b) change in the definition of high quality corporate bond: a change in the basket of high quality corporate bonds used to determine the discount rate for a defined benefit obligation (e.g. from AA-rated bonds to A-rated bonds); and
 - (c) change in the method of credit value adjustment (CVA) calculation to determine the probability of default (e.g. from historical approach to market-based approach).
- 26 Lastly, EFRAG also noted that some of the examples currently provided in paragraph 32 of IAS 8 may not be fully up-to-date in view of changes in other IFRS Standards. EFRAG recommended that for instance 'bad debts' be updated with the terminology used in IFRS 9 *Financial Instruments*.
- 27 The EFRAG Secretariat takes no issue with the proposed examples in Appendix 1 but is of the view that the IASB staff should consider more complex examples than the one proposed to illustrate the thought process and the interactions between accounting policies and estimates; possibly drawing on some of the fact patterns identified in ESMA's submission.

Questions for EFRAG TEG – CFSS

- 28 Do EFRAG TEG/CFSS members have questions or comments about the feedback summarised in this paper?
- 29 Do you consider that the proposed illustrative example (contained in Appendix 1) is appropriate? If not which alternative(s) could be considered?

Agenda Papers

- 30 In addition to this cover note, agenda paper 12-02 – *ASAF 04 Accounting Policies Illustrative examples* has been provided for the session.

Appendix 1 - Illustrative Example prepared by the IASB staff

- 31 This example has been prepared by the staff of the IASB to illustrate the thought process in distinguishing accounting policies from estimates.
- 32 The example deals only with inventories that are not interchangeable. It does not discuss the selection of a cost flow formula for inventories that are interchangeable.

Example

- 33 Do EFRAG TEG/CFSS members have questions or comments about the feedback summarised in this paper?
- 34 Do you consider that the approach proposed by the IASB staff to develop illustrative examples is appropriate? If not which alternative(s) could be considered?
- 35 Entity A has the following accounting policy for its inventories:
- (a) Inventories are stated at the lower of cost and net realisable value.
 - (b) Net realisable value is the estimated selling price for inventories less all estimated costs of completion and costs necessary to make the sale.

Accounting estimates used in applying the accounting policy

- 36 In applying this accounting policy for its inventories, Entity A uses accounting estimates for the following inputs because they cannot be measured with precision and involve the use of judgements or assumptions.
- 37 Paragraph 10 of IAS 2 states that the cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.
- 38 In converting materials into finished goods, Entity A incurs some fixed production overheads, such as depreciation and maintenance of factory buildings and equipment used in the production process, and the cost of factory management and administration. As part of its accounting policy in accordance with paragraphs 10 and 12 of IAS 2, in determining the costs of conversion of inventories, Entity A includes fixed production overheads in the cost of its inventories.
- 39 In doing so, Entity A determines the basis for allocating fixed production overheads. Production overheads are usually incurred centrally, and they cannot be allocated with precision to individual items of inventories unlike, for example, costs of purchasing items that are not interchangeable. Paragraph 14 of IAS 2 says that when the costs of conversion of each project are not separately identifiable, they are allocated between the products on a rational and consistent basis, for example based on the relative sales value of each product.
- 40 Consequently, Entity A needs to select the basis (ie the type of costs and the allocation method) for allocating overheads to determine the cost of inventories. Selecting the basis for allocating overheads involves the use of judgement or assumptions to estimate the amounts of overheads attributable to items of inventory. Thus, selecting that basis constitutes making an accounting estimate.
- 41 In assessing net realisable value, Entity A might also need to estimate:
- (a) the selling price for inventories; and
 - (b) costs of completion and costs necessary to make the sale.