ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS (IAS-8)

OBJECTIVE

The objective of this IAS 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 correction of errors.

DEFINITIONS

ACCOUNTING POLICIES are the specific principles, basis, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

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. Change in accounting estimates results from new information or new developments and accordingly are not corrections of errors.

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRSs) are Standards and Interpretations adopted by the International Accounting Standards Board (IASB).

They comprise:

(a) International financial Reporting Standards;

(b) International Accounting Standards; and

(c) Interpretations originated by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).

MATERIAL Omissions or misstatements of items are material if they could, individually or collectively; influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

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.

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

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.

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.

VOLUNTARY CHANGE

If the entity chooses to use the recent pronouncements of other standard setting bodies to apply the accounting policies then if the change in the said pronouncements result in change in accounting policy. The said change in accounting policy is voluntary change in accounting policy.

ACCOUNTING POLICIES

SELECTION AND APPLICATION OF ACCOUNTING POLICIES

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

- The IFRSs
- The Interpretations issued by the IASB; and
- Considering any relevant Implementation Guidance issued by the IASB for the standard or Interpretation.

In the absence of a Standard or an Interpretation that specifically applies to a transaction, other event or condition, management shall use its judgment 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 judgment described above, management shall refer to, and consider the applicability of, the following sources in descending order:

(a) the requirements and guidance in Standards and Interpretations dealing with similar and related issues; and

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

In making the judgment described above, 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 IFRSs.

CONSISTENCY OF ACCOUNTING POLICIES

An entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions.

CHANGES IN ACCOUNTING POLICIES

An entity shall change an accounting policy only if the change:

(a) is required by a Standard or an Interpretation; 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.

The following are not changes in accounting policies:

(a) the application of an accounting policy for transactions, other events or conditions that differ in substance from those previously occurring; and

(b) the application of a new accounting policy for transactions, other events or conditions that did not occur previously or were immaterial.

Exclusions from the application of IAS-8

The initial application of a policy to revalue assets in accordance with IAS 16 Property, Plant and Equipment or IAS 38 Intangible Assets is a change in an accounting policy to be dealt with as a revaluation in accordance with IAS 16 or IAS 38, rather than in accordance with this Standard.

Applying Changes in accounting Policies

(a) an entity shall account for a change in accounting policy resulting from the initial application of a Standard or an Interpretation in accordance with the specific transitional provisions, if any, in that Standard or Interpretation; and

(b) when an entity changes an accounting policy upon initial application of a Standard or an Interpretation that does not include specific transitional provisions applying to that change, or changes an accounting policy voluntarily, it shall apply the change retrospectively.

Retrospective application

When a change in accounting policy is applied retrospectively, the entity shall adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied.

CHANGES IN ACCOUNTING ESTIMATES

As there is lot of uncertainties inherent in the measurement of elements of financial statements, therefore, estimation is involved in the measurement such as: -

a) Bad debts;

b) Inventory obsolescence;

c) The fair value of financial assets or financial liabilities;

d) The useful life of, or expected pattern of consumption of the future economic benefits embodied in, depreciable assets; and

e) Warranty obligations

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

(b) the period of the change and future periods, if the change affects both

To the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it shall be recognized by adjusting the carrying amount of the related asset, liability or equity item in the period of the change.

ERRORS

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**

Q.1

Chemi Limited (CL) is engaged in manufacturing, purchasing and marketing of chemicals, including investments in other chemical manufacturing operations. During the year ended 31 December 2004, CL changed its accounting policy with respect to the following:

(i) In previous years, investments in associates were based on fair value method, where such investments were initially recognized at cost and carried at fair value to the balance sheet. Fair values of investments were determined on the basis of market value at the balance sheet date. Adjustments arising from re-measurement to fair value were reflected through statement of changes in equity. This policy has been changed to bring it in line with the Group's policy which states that investments are initially recognized at cost and at the subsequent reporting dates, the recoverable amounts are estimated in order to determine the extent of impairment losses and carrying amounts of investments are adjusted accordingly. Impairment losses are recognized as expenses.

(ii) Upto previous year, dividends and other distributions proposed after balance sheet date but before the financial statements were authorized for issue were recorded as liability. After the change in the 4th Schedule of the Companies Ordinance 1984, from the current year onwards, dividends and other distributions are to be recognized as a liability in the period in which they are declared.

Following information is available from the financial statement of CL:

	2004	**2003**	**2002**
Market value of shares of A Limited an associated company as at 3 1st December (Rupees per share)	45	47	50
Recoverable amount as per IAS 36 of A Limited (Rupees per share)	40	44	48
Net profit after tax as per old policy (Rupees in thousand)	4,004,044	3,144,509	Not given
Capital Reserves – (Rupees in thousand)	160,000	160,000	Not given

Dividend declaration has been as under:

For 2002 declared in 2003	Rupees 8.00 per share
For 2003 declared in 2004	Rupees 10.00 per share
For 2004 declared in 2005	Rupees 12.00 per share

Bonus shares declared and issued in 2003 @ 15%

Share Capital of CL as at 1 January 2003 – 256, 495,902 shares of Rs. 10 each

Unappropriated profits as at 1 January 2003 – Rs.8,218,203,000

Investment in A Limited - 100 million shares at Rs.50 per share.
The effective tax rate applicable to the company may be assumed at 35%.

Required:
A statement of changes in equity for the year ended 31 December 2003 and 2004 as per IAS 8 together with relevant notes. (You may round off all rupee figures to the nearest thousand). **(20)**

Q.2
XLS Limited is a listed company and engaged in the assembling of electrical appliances. During the year, the company changed its accounting policies in respect of the following:

1. It has started to capitalize the borrowing costs directly attributable to the qualifying assets. Upto June 30, 2005, the company recognized the borrowing costs as an expense in the year in which they were incurred.
2. Provision for bad debts shall be provided at 3% instead of 2%. The management feels that change of above policies will reflect a fair view of the company's financial position to the shareholders.

Extracts from the financial statements of the company before incorporation of above changes are given below:

	2006	**2005**
	Rs. in million	
Gross profit	486	410
General and administration expenses	(231)	(225)
Selling and distribution expense	(110)	(98)
Financial charges	(32)	(31)
Profit before tax	113	56
Income taxes	(30)	(14)
Profit after tax	83	42
Retained earnings – opening	452	410
Retained earnings – closing	535	452

Following additional information is also available:

1. Details of borrowing costs expensed out in current and prior periods which are directly attributable to the qualifying assets are as follows:

Year	**Amount Rs. in million**
June 30, 2006	16
June 30, 2005	12
June 30, 2004 and before	8

2. The change in the rate of provision for bad debts has been made on the recommendation of Recovery Department. The company has not yet made the provision as of June 30, 2006. The details of accounts receivables are as follows:
   Accounts receivable as at June 30, 2005 Rs. 100 million
   Accounts receivable as at June 30, 2006 Rs. 123 million
   Provision as at June 30, 2004 was Rs. 1.6 million.

3. Income tax rate was 25% for both years.

Required:

(a) Present the above changes in the Profit and Loss Account and Statement of Changes in Equity in accordance with the requirements of IAS-8 "Accounting Policies, Changes in Accounting Estimates and Errors".

(b) Draft an accounting policy about the borrowing costs for disclosure in the financial statements. **(17)**