FRC Financial Reporting Council

Mr Hans Hoogervorst
Chairman of the IASB
IFRS Foundation
30 Cannon Street
London
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2 November 2017

Dear Hans,

This letter sets out the comments of the UK Financial Reporting Council (FRC) on the Exposure Draft (ED) ED/2017/5 '*Accounting Policies and Accounting Estimates (Proposed amendments to IAS 8)*'. Our main comments on the ED are summarised below with our detailed responses to the consultation questions included in the appendix to this letter.

We support the IASB's objective of clarifying the criteria for distinguishing between a change in an accounting policy and a change in an accounting estimate, to encourage more consistent application of the requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (IAS 8).

We agree with the decision to revise the definition of 'accounting policies' and to replace the definition of 'a change in accounting estimate' with a definition of 'accounting estimates', to make the distinction from accounting policies clearer. We also agree with the proposed definition of 'accounting estimates'. However, the proposed definitions leave some potential for overlap in interpretation; the retention of the term 'practices' in the definition of 'accounting policies' could be interpreted too broadly without explanation of its intended meaning in this context. For example, certain estimation techniques or valuation techniques—which are accounting estimates—could be described as practices.

The need for clearer articulation of the definitions is demonstrated by the fact it was felt necessary to propose for IAS 8 to include of a specific rule in relation to the treatment of cost formulas for ordinarily interchangeable inventories. While we understand that this is a matter that frequently leads to queries on the application of the requirements in IAS 8, in our view the revised definitions should be sufficiently clear to enable companies to make the determination without recourse to a specific rule for this circumstance.

Moreover, the proposed rule does not appear to be derived from or consistent with the definitions proposed in paragraph 5 of the ED and appears to conflict with paragraph 35 of IAS 8. In our view, the measurement base in this case is the accounting policy (i.e. that

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inventory is accounted for at the lower of cost and net realisable value) and the cost formula is an accounting estimate selected to be used in applying that accounting policy.

Furthermore, if a cost formula is an accounting policy and it is not selected on the basis of the consumption pattern of inventory (as asserted in paragraph 32B), it is not clear in what circumstances the threshold for a change in accounting policy set out in paragraph 14(b) of IAS 8 could be met and the change in cost formula permitted.

If you would like to discuss these comments, please contact me or Rosalind Szentpéteri on 020 7492 2474.

Yours sincerely

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Appendix – FRC responses to consultation questions

> **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?

We agree with replacing the term 'bases' with the term 'measurement bases' to improve the clarity of the definition of 'accounting policies', and with the removal of the term 'rules' because in our view IFRS should be principles-based. We also support the removal of the term 'conventions' because it is not clear what this refers to, particularly given that 'conventions' would seem to be captured as a sub-set of 'practices'.

We understand that the term 'practices' has been retained to avoid the perception that the definition of 'accounting policies' has been narrowed rather than clarified however, it should be clear what it is intended to capture. Retaining the term may help to highlight that the definition includes those accounting policies developed in the absence of specific guidance in IFRS, as described in paragraphs 10-12 of IAS 8, and any practical expedients applied (which constitute a departure from the principles in IFRS). If this is the intention then we suggest this is stated explicitly in the Standard to ensure that 'practices' is not interpreted too broadly or in a manner that blurs the distinction between accounting policies and accounting estimates.

> **Question 2**
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> 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?

We welcome the IASB's decision to remove the definition of 'a change in accounting estimate' and instead define 'accounting estimates'. This approach should make it easier to distinguish accounting estimates from accounting policies. While we appreciate that it is difficult to eliminate all ambiguity from the definitions and that professional judgement will continue to be

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needed when making the determination, we believe that the distinction between accounting policies and accounting estimates could be articulated more clearly.

The retention of the term ‘practices’ in the definition of ‘accounting policies’ (without clarification of its meaning in this context) leaves potential for overlap in interpretation with the proposed definition of ‘accounting estimates’. For example, estimation techniques and valuation techniques could be described as ‘practices’ in accordance with how the term is commonly understood, yet we are in agreement with the IASB that these are accounting estimates, not accounting policies.

We support the definition of ‘accounting estimates’ in paragraph 5. We believe that defining ‘accounting estimates’ at this level of granularity will enable clearer distinction between changes in accounting estimates and other changes such as the availability of new or more accurate data. In our view, the emphasis that the reference to ‘judgements’ in the definition of ‘accounting estimates’ relates to only those judgements that are used in applying the measurement aspect of an accounting policy is crucial because other judgements which are not accounting estimates may also be necessary when applying an accounting policy (for example, judgements in relation to whether recognition criteria are met).

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?

We support the IASB’s proposal to provide further guidance regarding selecting an estimation technique or valuation technique. We note that paragraph 32A is consistent with the requirement in paragraph 66 of IFRS 13 *Fair Value Measurement* concerning the treatment of a change in valuation techniques.

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?

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We are aware of the contention around whether a change in cost formulas for ordinarily interchangeable inventories is a change in accounting policy or a change in accounting estimate and support the IASB's aim of clarifying this matter. However, in our view the principles in IAS 8 should be sufficiently clear to enable companies to determine the appropriate treatment without recourse to a rule for a specific circumstance. Where more guidance is needed, illustrative examples are a better way to demonstrate the application of the principles but it is important that the definitions in the Standard itself are also redrafted to make their application clearer.

Moreover, the rule in paragraph 32B of the ED does not appear to be derived from or consistent with the definitions of 'accounting estimates' and 'accounting policies' set out in paragraph 5. Paragraph 32B states that "selecting one of the two cost formulas… does not involve the use of judgement or assumptions to determine the sequence in which those inventories are sold", and that therefore selecting a cost formula constitutes selecting an accounting policy. This argument would be valid only if a cost formula is *never* selected on the basis that it best approximates how inventory is consumed by the business, which we do not believe to be the case.

For example, when such inventory is regularly used in production or sold, the FIFO cost formula will often best approximate the consumption pattern and be selected on that basis. We also note that paragraphs BC10-BC11 of IAS 2 *Inventories* (IAS 2) explicitly acknowledge that, contrary to the assertion in paragraph 32B of the ED, cost formulas are an approximation of the consumption pattern of inventory, hence the fact that use of the LIFO formula is prohibited because it "is generally not a reliable representation of actual inventory flows" and imposes "an unrealistic cost flow assumption" The measurement base applied to inventories is the accounting policy (i.e. that inventories are measured at the lower of cost and net realisable value) and the cost formula is an accounting estimate selected to be used in applying that accounting policy.

Paragraph 32B also appears to conflict with 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". Given the contention around the treatment of cost formulas, paragraph 35 implies that a change in the cost formula applied to inventory should be treated as a change in accounting estimate.

We also note that paragraph 14 of IAS 8 sets a threshold that must be met for an entity to change an accounting policy. It is permitted "only if the change: (a) is required by IFRS; 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." If the selection of a cost formula is the selection of an accounting policy and it is not based on an approximation of the consumption pattern of inventory (as asserted in paragraph 32B of the ED), it is not clear in what circumstances the criteria in paragraph 14(b) could be met and a change in cost formula permitted if it is not required by IFRS as set out in paragraph 14(a).

Finally, it seems odd to place paragraph 32B under the 'accounting estimates' heading when the purpose of the paragraph is to state that this is not a change of accounting estimate. In

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our view, if paragraph 32B is retained by the IASB, it should be included in IAS 2 rather than in IAS 8 to avoid inappropriate analogies being drawn in relation to other circumstances.

Question 5

Do you have any other comments on the proposals?

We suggest that, while amending IAS 8, the IASB takes the opportunity to clarify the requirements for reporting of the effect of changes in estimates. The ED proposes no change to paragraph 39, which merely requires disclosure of the nature and amount of a change in an estimate. We suggest this paragraph is amended to require the disclosure of the financial statement line items that are affected. If the IASB is not minded to make this change as part of the current amendments it should be considered within the Primary Financial Statements project.

In our view, IAS 8 should state that in some circumstances a change in an accounting estimate could result from the correction of an error and should be treated as such (for example, if a material error in the calculation method is identified and corrected). IAS 8 should contain guidance to assist companies in distinguishing the correction of errors of this nature from changes in accounting estimates.

We recommend that the title of IAS 8 is updated to reflect the amendments proposed in the ED (i.e. to refer to 'accounting estimates' rather than 'changes in accounting estimates').

Paragraph 54F of the ED could also be drafted more concisely, stating simply that the requirements are to be applied prospectively from the effective date, with early application permitted.

We recommend that the proposed changes are published at the same time as the forthcoming amendments to IAS 8 (*Accounting policy changes*) to avoid amending IAS 8 twice within a short period.

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