HKAS 8 – Accounting policies, changes in accounting estimates and errors
(Relevant to AAT Examination Paper 7 – Financial Accounting)
Dr. M H Ho, School of Continuing & Professional Studies, The Chinese University of Hong Kong

This article discusses the selection of and changes in accounting policies, changes in accounting estimates and corrections of errors.

1. ACCOUNTING POLICIES

(a) Definition of accounting policies

HKAS 8 defines accounting policies as "the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements".

(b) How to select an appropriate accounting policy

Usually, management of an entity should select an accounting policy that complies with:

- a HKFRS dealing with similar transactions; and
- the recognition and measurement criteria for assets, liabilities, income and expenses in the *Conceptual Framework.*

In the absence of a HKFRS that applies to a particular transaction, HKAS 8 requires management to select an accounting policy that:

- is relevant for making economic decisions; and
- is reliable in presenting information about the transactions and the financial statements:
  - present faithfully the financial position, performance and cash flows of an entity;
  - reflect the economic substance of transactions;
  - is free from bias, and is prudent and complete.

(c) Changes in accounting policies

When should or can an accounting policy be changed?

Accounting policies are normally consistently applied to transactions under same category and from period to period to ensure comparability of financial statements over time. HKAS 8 allows a change in accounting policy only if the change:

- is required by a HKFRS (including the initial application of a HKFRS); or
- will result in a more relevant and reliable presentation of the transactions, financial position, financial performance and cash flows of an entity.

Example 1
EFG Limited has previously recognized all its finance costs as an expense in the period in which they are incurred. HKAS 23 (Revised) applies to annual accounting periods beginning on or after 1January 2009. The management of EFG Limited now wishes to capitalize interest on borrowings incurred to finance the construction of plant for the

financial year ended 31 December 2009. Does the capitalization of finance costs represent a change in accounting policy?

Discussion:
HKAS 8 allows a change in accounting policy if the change is required by a standard; in this case this is HKAS 23 (Revised). Therefore the decision represents a change in accounting policy. This decision leads to changes in:
- Recognition – the finance costs previously written off are now included as part of costs of plant
- Presentation – the finance costs are now presented in the statement of financial position (as part of costs of plant) rather than in the income statement

Applying a change in accounting policies

When an entity changes an accounting policy upon initial application of a HKFRS, or changes an accounting policy voluntarily, it shall apply the change retrospectively. Retrospective application means the new accounting policy should be applied to transactions as if that policy had always been applied. Adjustments should be made to the opening balance of each affected component of equity and other comparative amounts for the prior period.

Disclosures

When a change in accounting policy has an effect on the current period or any prior period presented, an entity should disclose:
- the title of the HKFRS
- the nature of the change
- the change in accounting policy is made in accordance with its transitional provision and a description of that transitional provision and its effect, if applicable
- the amount of the adjustment recognized in the current and prior periods
- how, why and when the change of policy applies, if retrospective application is impracticable
- the amount of the adjustment for each financial statement line item affected; and if HKAS 33 Earning Per Share applies, the basic and diluted earnings per share

2. ACCOUNTING ESTIMATES

(a) Nature of change of accounting estimate

There are many uncertainties inherent in business activities. Many items in the financial statements cannot be measured precisely and they need to be estimated. Estimation involves judgments based on the latest available, reliable information. For example:
- estimates of the amount of accounts receivable that will not be recovered are made by considering the economic condition
- the useful life of a tangible non-current asset is estimated based on the proportion of the economic benefits of the asset consumed
- the amount needed for a provision can be determined using techniques such as discounted cash flows

If changes occur in the circumstances on which the estimate was based or as a result of new information or more experience, an estimate may need revising. It will then be necessary to adjust:

- the carrying amount of an asset or a liability, or
- the amount of the periodic consumption of an asset.

Example 2

A machine has a depreciable amount of $5,000 to be written off over five years using the straight-line method. The company is now proposing to depreciate machine using the reducing balance method at 40% per year and considers that this can better represent the consumption pattern of the economic benefits of the machine. Will the change of depreciation method be a change in accounting estimate?

Discussion:

HKAS 8 specifies that a change in the measurement basis applied is a change in an accounting policy, and is not a change in an accounting estimate. Therefore, the choice of method of depreciation is a type of accounting estimates whereas the policy of writing off the cost of machine over its useful live is an accounting policy.

(b) Recognition of the changes in accounting estimates

HKAS 8 states the effect of a change in an accounting estimate shall be recognized:

- in the income statement in the period of the change, and in future periods if the change affects them
- by adjusting the carrying amount of the related asset, liability or equity item in the period of the change, if applicable

Example 3

Following the information in Example 2, suppose that the machine was purchased during the year ended 31 December 2009 and the year of change of depreciation method is 2010. It is the company's policy to charge a full year's depreciation in the year of acquisition.

According to the requirements of HKAS 8, the company should recognize, in the period of the change, effects of the change in the consumption pattern of the economic benefits of the machine. The accounting entries to record the annual depreciation for the year ended 31 December 2010 should be:

Dr. Depreciation expenses	$1,600	
Cr. Accumulated depreciation		$1,600
[($5,000 - $5,000/5) x 40%]		

(c) Disclosures

An entity shall disclose the nature and amount of the change that has an effect in the current period or is expected to have any effect in future periods, except when it is impracticable to estimate that effect.

3. PRIOR PERIOD ERRORS

(a) Definition of prior period errors

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:

- was available when financial statements for those periods were authorized for issue; and
- could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements". (para. 5 of HKAS 8)

Example 4

During 2010 ABC Limited discovered that certain items of research expenditure, which involves the design of new products, amounting to $3 million had been mistakenly classified as deferred development expenditure as at 31 December 2009.

Discussion:

This is a prior period error because this understated research expenditure in the entity's income statement and overstated deferred development expenditure in the statement of financial position for prior periods arising from a misuse of reliable information in the preparation and presentation of those financial statements.

(b) Correction of prior period errors

Material prior period errors, as required by HKAS 8, are to be corrected retrospectively by restating:

- the comparative amounts for the prior period(s) presented in which the error occurred; or
- the opening balances of assets, liabilities and equity for the earliest prior period presented, if the error occurred before the earliest prior period presented.

Retrospective restatement refers to correcting the recognition, measurement and disclosure of assets, liabilities, equity, income and expenses presented in the financial statements as if a prior period error had never occurred.

Example 5

Following the information in Example 4, the income statement of ABC Limited for years ended 31 December 2010 and 2009 are as follows:

	2010	2009
	$000	$000
Revenue	50,000	48,000
Cost of sales	(33,500)	(30,200)
Gross profit	16,500	17,800
Distribution costs	(1,600)	(1,800)
Administrative expenses	(2,000)	(1,700)
Profit before tax	12,900	14,300
Income tax expenses	(1,000)	(800)
PROFIT FOR THE YEAR	11,900	13,500

Additional information:

1. In year 2009, the director of ABC Limited decided that the deferred development expenditure of $3 million to be included in the costs of closing inventory because this project is closely related to the designing of new products.
2. It is the policy of ABC Limited to group research expenditure under 'administrative expenses' in the income statement.

In the case of ABC Limited, the value of closing inventory has been overstated while the cost of sales and administrative expenses have been understated in the financial statements for the year ended 31 December 2009. The closing inventory in 2009 will be carried forward to 2010, as a result, the value of the cost of sales will be overstated in the financial statements for the year ended 31 December 2010.

Since material prior period errors are to be corrected retrospectively by restating the comparative amounts for the prior period presented in which the error occurred, the income statement of the company should be presented as:

	2010	2009
	$000	$000
Revenue	50,000	48,000
Cost of sales		
2009 (30,200 + 3,000)		(33,200)
2010(33,500 - 3,000)	(30,500)	
Gross profit	19,500	14,800
Distribution costs	(1,600)	(1,800)
Administrative expenses		
2009 (1,700 + 3,000)		(4,700)
2010	(2,000)	
Profit before tax	15,900	8,300
Income tax expenses	(1,000)	(800)
PROFIT FOR THE YEAR	14,900	7,500

(c) Disclosures

When there is correction of prior period errors, the entity should disclose:

- the nature of the prior period error
- the amount of the correction
  - on each financial statement item presented for the prior periods;
  - for basic and diluted earnings per share if HKAS 33 applies, and
  - at the beginning of the earliest prior period presented
- a description of the circumstances that led to the retrospective restatement is impracticable and of how and from when the error has been corrected

IMPRACTICABILITY IN RETROSPECTIVE APPLICATION AND IN RETROSPECTIVE RESTATEMENT

HKAS 8 specifies the circumstances where it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error for a particular prior period:

- effects of the retrospective application and retrospective restatement are not determinable; or
- assumptions about what management's intent would have been in that period is required; or
- significant estimates of amounts are required and it is impossible to distinguish objectively information about those estimates.

CONCLUSION

HKAS 8 prescribes the criteria for selecting and changing accounting policies, making changes in accounting estimates and corrections of errors so that an entity's financial statements are relevant and reliable and can be compared with its financial statements over time and with the financial statements of other entities.

<u>Reference:</u>
HKAS 8 "Accounting Policies, Changes in Accounting Estimates and Errors"

Modified in December 2011