

# CHAPTER - 6

## Ind AS 8: Accounting Policies, Changes in Accounting Estimates and Errors

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### Question 1

Entity ABC acquired a building for its administrative purposes and presented the same as property, plant and equipment (PPE) in the financial year 20X1-20X2. During the financial year 20X2-20X3, it relocated the office to a new building and leased the said building to a third party. Following the change in the usage of the building, Entity ABC reclassified it from PPE to investment property in the financial year 20X2-20X3. Should Entity ABC account for the change as a change in accounting policy?

### Answer

Paragraph 16(a) of Ind AS 8 provides that the **application of an accounting policy for transactions, other events or conditions that differ in substance from those previously occurring are not changes in accounting policies.**

As per Ind AS 16, 'property, plant and equipment' are tangible items that:

- (a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
- (b) are expected to be used during more than one period."

As per Ind AS 40, 'investment property' is property (land or a building, or part of a building, or both) held (by the owner or by the lessee as a right-of-use asset) to earn rentals or for capital appreciation or both, rather than for:

- (a) use in the production or supply of goods or services or for administrative purposes; or
- (b) sale in the ordinary course of business."

As per the above definitions, whether a building is an item of property, plant and equipment (PPE) or an investment property for an entity depends on the purpose for which it is held by the entity. It is thus possible that due to a change in the purpose for which it is held, a building that was previously classified as an item of property, plant and equipment may warrant reclassification as an investment property, or vice versa. Whether a building is in the nature of PPE or investment property is determined by applying the definitions of these terms from the perspective of that entity. Thus, the classification of a building as an item of property, plant and equipment or as an investment property is not a matter of an accounting policy choice.

Accordingly, a **change in classification of a building from property, plant and equipment to investment property due to change in the purpose for which it is held by the entity is not a change in an accounting policy.**

### Question 2

ABC Ltd. changed its method adopted for inventory valuation in the year 20X2-20X3. Prior to the change, inventory was valued using the first in first out method (FIFO). However, it was felt that in order to match current practice and to make the financial statements more relevant and reliable, a weighted average valuation model would be more appropriate.

The effect of the change in the method of valuation of inventory was as follows:

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- 31<sup>st</sup> March, 20X1 – Increase of ₹ 10 million
- 31<sup>st</sup> March, 20X2 – Increase of ₹ 15 million
- 31<sup>st</sup> March, 20X3 – Increase of ₹ 20 million

Profit or loss under the FIFO valuation model are as follows:

₹ million

	20X2-20X3	20X1-20X2
Revenue	324	296
Cost of goods sold	(173)	(164)
<b>Gross profit</b>	<b>151</b>	<b>132</b>
Expenses	(83)	(74)
<b>Profit</b>	<b>68</b>	<b>58</b>

Retained earnings at 31<sup>st</sup> March, 20X1 were ₹ 423 million

You are required to present the impact of change in accounting policy in the profit or loss and produce an extract of the statement of changes in equity in accordance with Ind AS 8.

Note: Present all amounts in ₹ million

**Answer**

**Profit or loss under weighted average valuation method is as follows:**

	20X2-20X3	20X1-20X2 (Restated)
Revenue	324	296
Cost of goods sold	(168)	(159)
<b>Gross profit</b>	<b>156</b>	<b>137</b>
Expenses	(83)	(74)
<b>Profit</b>	<b>73</b>	<b>63</b>

**Statement of changes in Equity (extract)**

	Retained earnings	Retained earnings (Original)
At 1 <sup>st</sup> April, 20X1	423	423
Change in inventory valuation policy	10	-
<b>At 1<sup>st</sup> April, 20X1 (Restated)</b>	<b>433</b>	<b>-</b>
Profit for the year 20X1-20X2	63	58
<b>At 31<sup>st</sup> March, 20X2</b>	<b>496</b>	<b>481</b>
Profit for the 20X2-20X3	73	68
<b>At 31<sup>st</sup> March, 20X3</b>	<b>569</b>	<b>549</b>

**Question 3**

During 20X2, Delta Ltd., changed its accounting policy for depreciating property, plant and equipment, so as to apply a component approach completely, whilst at the same time adopting the revaluation model.

In years before 20X2, Delta Ltd.'s asset records were not sufficiently detailed to apply a component approach fully. At the end of 20X1, management commissioned an engineering survey, which provided information on the components held and their fair values, useful lives, estimated residual values and depreciable amounts at the beginning of 20X2. However, the survey did not provide a sufficient basis for reliably estimating the cost of those components that had not previously been accounted for separately, and the existing records before the survey did not permit this information to be reconstructed.

Delta Ltd.'s management considered how to account for each of the two aspects of the accounting change. They determined that it was not practicable to account for the change to a fuller component approach retrospectively, or to account for that change prospectively from any earlier date than the start of 20X2. Also, the change from a cost model to a revaluation model is required to be accounted for prospectively. Therefore, management concluded that it should apply Delta Ltd.'s new policy prospectively from the start of 20X2.

Additional information:

(i) Delta Ltd.'s tax rate is 30%

(ii) Property, plant and equipment at the end of 20X1:

Cost	₹ 25,000
Depreciation	<u>₹ 14,000</u>
Net book value	<u>₹ 11,000</u>

(iii) Prospective depreciation expense for 20X2 (old basis) ₹ 1,500

(iv) Some results of the engineering survey:

Valuation	₹ 17,000
Estimated residual value	₹ 3,000
Average remaining asset life	7 years
Depreciation expense on existing property, plant and equipment for 20X2 (new basis)	₹ 2,000

You are required to prepare relevant note for disclosure and show the impact of each item affected on financial statements by the analysis of stated issue in accordance with Ind AS 8.

**Answer**

**Extract from the notes**

From the start of 20X2, Delta Ltd., **changed its accounting policy** for depreciating property, plant and equipment, so as to apply much more fully a components approach, whilst at the same time **adopting the revaluation model**. Management takes the view that this policy provides reliable and more relevant information because it deals more accurately with the components of property, plant and equipment and is based on up-to-date values. The policy has been **applied prospectively** from the start of 20X2 because it was **not practicable** to estimate the effects of applying the policy either **retrospectively**, or prospectively from any earlier date. Accordingly, the adoption of the new policy

has no effect on prior years. The effect on the current year is to increase the carrying amount of property, plant and equipment at the start of the year by ₹ 6,000 (17,000 - 11,000); increase the opening deferred tax provision by ₹ 1,800 (6,000 x 30%); create a revaluation surplus (OCI) at the start of the year of ₹ 4,200 (6,000 - 1,800); increase depreciation expense by ₹ 500 (2,000 - 1,500); and reduce tax expense on depreciation by ₹ 150 (500 x 30%).

#### **Question 4**

In 20X3-20X4, after the entity's 31<sup>st</sup> March 20X3 annual financial statements were approved for issue, a latent defect in the composition of a new product manufactured by the entity was discovered (that is, a defect that could not be discovered by reasonable or customary inspection). As a result of the latent defect the entity incurred ₹ 1,00,000 in unanticipated costs for fulfilling its warranty obligation in respect of sales made before 31<sup>st</sup> March 20X3. An additional ₹ 20,000 was incurred to rectify the latent defect in products sold during 20X3-20X4 before the defect was detected and the production process rectified, ₹ 5,000 of which relates to items of inventory at 31<sup>st</sup> March 20X3. The defective inventory was reported at cost ₹ 15,000 in the 20X2-20X3 financial statements when its selling price less costs to complete and sell was estimated at ₹ 18,000. The accounting estimates made in preparing the 31<sup>st</sup> March 20X3 financial statements were appropriately made using all reliable information that the entity could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Analyse the above situation in accordance with relevant Ind AS.

#### **Answer**

**Ind AS 8** is applied in selecting and applying accounting policies, and accounting for changes in accounting policies, changes in accounting estimates and corrections of prior period errors.

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. This change in accounting estimate is an outcome of the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

Further, the **effect of change in an accounting estimate, shall be recognised 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.

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 approved 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.

On the basis of above provisions, the given situation would be dealt as follows:

The defect was **neither known** nor reasonably possible to detect at 31<sup>st</sup> March 20X3 or before the financial statements were approved for issue, so understatement of the warranty provision ₹ 1,00,000

and overstatement of inventory ₹ 2,000 (Working Note) in the 31<sup>st</sup> March 20X3 financial statements are **not a prior period error**.

The **effects of the latent defect** that relate to the entity's financial position at 31<sup>st</sup> March 20X3 are **changes in accounting estimates**.

In preparing its financial statements for 31<sup>st</sup> March 20X3, the entity made the warranty provision and inventory valuation appropriately using all reliable information that the entity could reasonably be expected to have obtained and had taken into account the same in the preparation and presentation of those financial statements.

**Consequently, the additional costs are expensed in calculating profit or loss for 20X3-20X4.**

Working Note:

Inventory is measured at the lower of cost (i.e. ₹ 15,000) and fair value less costs to complete and sell (i.e. ₹ 18,000 originally estimated minus ₹ 5,000 costs to rectify latent defect) = ₹ 13,000

**Question 5**

During 20X4-X5, Cheery Limited discovered that some products that had been sold during 20X3-X4 were incorrectly included in inventory at 31<sup>st</sup> March, 20X4 at ₹ 6,500.

Cheery Limited's accounting records for 20X4-X5 show sales of ₹ 1,04,000, cost of goods sold of ₹ 86,500 (including ₹ 6,500 for the error in opening inventory), and income taxes of ₹ 5,250.

In 20X3-X4, Cheery Limited reported:

	₹
Sales	73,500
Cost of goods sold	(53,500)
<b>Profit before income taxes</b>	<b>20,000</b>
Income taxes	(6,000)
<b>Profit</b>	<b>14,000</b>
Basic and diluted EPS	2.8

The 20X3-X4 opening retained earnings was ₹ 20,000 and closing retained earnings was ₹ 34,000. Cheery Limited's income tax rate was 30% for 20X4-X5 and 20X3-X4. It had no other income or expenses.

Cheery Limited had ₹ 50,000 (5,000 shares of ₹ 10 each) of share capital throughout, and no other components of equity except for retained earnings.

State how the above will be treated/accounted in Cheery Limited's Statement of profit and loss, statement of changes in equity and in notes wherever required for current period and earlier period(s) as per relevant Ind AS.

**Answer**

**Cheery Limited**

**Extract from the Statement of profit and loss**

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	20X4-X5	20X3-X4 (Restated)
	₹	₹
Sales	1,04,000	73,500
Cost of goods sold	(80,000)	(60,000)
<b>Profit before income taxes</b>	<b>24,000</b>	<b>13,500</b>
Income taxes	(7,200)	(4,050)
<b>Profit</b>	<b>16,800</b>	<b>9,450</b>
Basic and diluted EPS	3.36	1.89

### Statement of Changes in Equity

	Share capital	Retained earnings	Total
Balance at 31 <sup>st</sup> March, 20X3	50,000	20,000	70,000
Profit for the year ended 31 <sup>st</sup> March, 20X4 as restated	-	9,450	9,450
<b>Balance at 31<sup>st</sup> March, 20X4</b>	<b>50,000</b>	<b>29,450</b>	<b>79,450</b>
Profit for the year ended 31 <sup>st</sup> March, 20X5	-	16,800	16,800
<b>Balance at 31<sup>st</sup> March, 20X5</b>	<b>50,000</b>	<b>46,250</b>	<b>96,250</b>

### Extract from the Notes

Some products that had been sold in 20X3-X4 were incorrectly included in inventory at 31<sup>st</sup> March, 20X4 at ₹ 6,500. The financial statements of 20X3-X4 have been restated to correct this error. The effect of the restatement on those financial statements is summarized below:

	Effect on 20X3-X4
(Increase) in cost of goods sold	(6,500)
Decrease in income tax expenses	1,950
(Decrease) in profit	(4,550)
(Decrease) in basic and diluted EPS	(0.91)
(Decrease) in inventory	(6,500)
Decrease in income tax payable	1,950
(Decrease) in equity	(4,550)

There is no effect on the balance sheet at the beginning of the preceding period i.e. 1<sup>st</sup> April, 20X3.

### Question 6

In its financial statements for the year ended 31<sup>st</sup> March, 20X2, Y Ltd. reported ₹ 73,500 revenue (sales), ₹ 53,500 cost of sales, ₹ 6,000 income tax expense, ₹ 20,000 retained earnings at 1<sup>st</sup> April, 20X1 and ₹ 34,000 retained earnings at 31<sup>st</sup> March, 20X2.

In 20X2-20X3, after the 20X1-20X2 financial statements were approved for issue, Y Ltd. discovered that

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some products sold in 20X1-20X2 were incorrectly included in inventories at 31<sup>st</sup> March, 20X2 at their cost of ₹ 6,500.

In 20X2-20X3, Y Ltd. changed its accounting policy for the measurement of investments in associates after initial recognition from cost model to the fair value model as per Ind AS 109. It acquired its only investment in an associate for ₹ 3,000 many years ago. The associate's equity is not traded on a securities exchange (that is, a published price quotation is not available). The fair value of the investment was determined reliably using an appropriate equity valuation model on 31<sup>st</sup> March, 20X3 at ₹ 25,000 (20X1-20X2: ₹ 20,000 and 20X0-20X1: ₹ 18,000).

In 20X2-20X3, as a result of usage of improved lubricants, Y Ltd. reassessed the useful life of Machine A from four years to seven years. Machine A is depreciated on the straight-line method to a Nil residual value. It was acquired for ₹ 6,000 on 1<sup>st</sup> April, 20X0.

Inventories of the type manufactured by Machine A were immaterial at the end of each reporting period.

Y Ltd.'s accounting records for the year ended 31<sup>st</sup> March, 20X3, before accounting for change in accounting policy and change in accounting estimate, record ₹ 1,04,000 revenue (sales), ₹ 86,500 cost of sales (including ₹ 6,500 for the error in opening inventory and ₹ 1,500 depreciation for Machine A) and ₹ 5,250 income tax expense.

Y Ltd. presents financial statements with one year of comparative information.

For simplicity, the tax effect of all items of income and expenses should be assumed to be 30% of the gross amount.

Draft an extract showing how the correction of the prior period error, change in accounting policy and change in accounting estimate could be presented in the Statement of Profit and Loss and Statement of Changes in Equity (Retained Earnings) and disclosed in the Notes of Y Ltd. for the year ended 31<sup>st</sup> March, 20X3.

### Answer

#### Extract of Y Ltd.'s Statement of Profit and Loss for the year ended 31<sup>st</sup> March, 20X3

	20X2-20X3	Reference to W.N.	20X1-20X2 Restated	Reference to W.N.
	₹		₹	
Revenue	1,04,000		73,500	
Cost of sales (20X1-20X2 previously ₹ 53,500)	(79,100)	1	(60,000)	4
Gross profit	24,900		13,500	
Other income - change in measurement policy i.e. value of investment in associate at FVTPL	5,000	2	2,000	5
<b>Profit before tax</b>	<b>29,900</b>		<b>15,500</b>	
Income tax expense	(8,970)	3	(4,650)	6
<b>Profit for the year</b>	<b>20,930</b>		<b>10,850</b>	

#### Extract of Y Ltd.'s Statement of Changes in Equity (Retained Earnings) for the year ended 31<sup>st</sup> March, 20X3

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	20X2-20X3	Reference to W.N.	20X1-20X2 Restated	Reference to W.N.
	₹		₹	
Retained earnings at the beginning of the year (previously stated)	34,000		20,000	
- effect of correction of a prior period error	(4,550)	7	-	
- effect of a change in accounting policy	11,900	13	10,500	12
Retained earnings at the beginning of the year (restated)	41,350		30,500	
Profit for the year	20,930		10,850	
Retained earnings at the end of the year	62,280		41,350	

**Extract of Y Ltd.'s Notes to the Financial Statements for the year ended 31<sup>st</sup> March, 20X3**

### **Note A: Change in Accounting Estimates**

Due to usage of improved lubricants the **estimated useful life** of the machine used for production was **increased** from four years to seven years. The effect of the change in the useful life of the machine is to **reduce the depreciation** allocation by ₹ 900 in 20X2-20X3 and 20X3-20X4. The after-tax effect is an **increase in profit** for the year of ₹ 630 for each of the two years.

**Depreciation expense in 20X4-20X5 to 20X6-20X7 is increased by ₹ 600** because of revision in the useful life of machinery, as under the initial estimate, the asset would have been fully depreciated at the end of 20X3-20X4. The after-tax effect for these three years is a **decrease in profit for the year by ₹ 420 per year**.

### **Note B: Correction of Prior Period Error**

In 20X2-20X3 the entity identified that ₹ 6,500 products that had been sold in 20X1-20X2 were **included erroneously in inventory** at 31<sup>st</sup> March, 20X2. The financial statements of 20X1-20X2 have been restated to correct this error. The effect of the restatement is ₹ 6,500 **increase in the cost of sales** and ₹ 4,550 **decrease in profit** for the year ended 31<sup>st</sup> March, 20X2 after decreasing income tax expense by ₹ 1,950. This resulted in ₹ 4,550 **(decrease) restatement of retained earnings** at 31<sup>st</sup> March, 20X2.

### **Note C: Change in Accounting Policy**

In 20X2-20X3 the entity changed its accounting policy for the **measurement of investments in associates from cost model to fair value model** as per Ind AS 109. Management judged that this policy provides reliable and more relevant information because dividend income and changes in fair value are inextricably linked as integral components of the financial performance of an investment in an associate and measurement at fair value is necessary if that financial performance is to be reported in a more meaningful way. This change in accounting policy has been accounted for retrospectively. The comparative information has been restated. A new line item, 'Other income – change in the fair value of investment in associate', has been added in the Statement of Profit and Loss and Retained Earnings. The effect of the restatement has been to **add income of ₹ 2,000** as a result of the increase in value of the associate **during the year ended 31<sup>st</sup> March, 20X2** which resulted in ₹ 1,400 **increase in profit** for the year (after including a resulting increase in income tax expense of ₹ 600). This, together with ₹ 10,500 **(increase) restatement of retained earnings** at 31<sup>st</sup> March, 20X1, resulted in a ₹ 11,900

increase in retained earnings at 31<sup>st</sup> March, 20X2. Furthermore, **profit for the year ended 31<sup>st</sup> March, 20X3 was ₹ 3,500 higher** (after deducting ₹ 1,500 tax effect) **as a result of recording a further ₹ 5,000 (W.N.2) increase in the fair value** of the investment in an associate.

Working Notes:

1. ₹ 86,500 (given) minus ₹ 6,500 correction of error (now recognised as an expense in 20X1-20X2) minus ₹ 900 (W.N.9) effect of the change in accounting estimate.
2. ₹ 25,000 fair value (20X2-20X3) minus ₹ 20,000 fair value (20X1-20X2) = ₹ 5,000 (the effect of applying the new accounting policy (fair value model) in 20X2-20X3).
3. ₹ 5,250 + ₹ 1,950 (W.N.8) + 30% (₹ 900 (W.N.9) reduction in depreciation resulting from the change in accounting estimate) + 30% (₹ 5,000 increase in the fair value of investment property - change in accounting policy) = ₹ 8,970.
4. ₹ 53,500 as previously stated + ₹ 6,500 (products sold and incorrectly included in closing inventory in 20X1-20X2) = ₹ 60,000 (that is, the prior period error is corrected retrospectively by restating the comparative amounts).
5. ₹ 20,000 fair value (20X1-20X2) minus ₹ 18,000 fair value (20X0-20X1) = ₹ 2,000 (the effect in 20X1-20X2 of the change in accounting policy for investments in associates from the cost model to the fair value model).
6. ₹ 6,000 as previously stated minus ₹ 1,950 (W.N.8) correction of prior period error + 30% (₹ 2,000 change in accounting policy) = ₹ 4,650.
7. ₹ 6,500 (products sold and incorrectly included in inventory in 20X1 -20X2) - ₹ 1,950 (W.N.8) (tax overstated in 20X1-20X2) = ₹ 4,550.
8. ₹ 6,500 (products sold and incorrectly included in inventory in 20X1 -20X2) x 30% (income tax rate) = ₹ 1,950.
9. ₹ 1,500 depreciation (using old estimate, that is, ₹ 6,000 cost ÷ 4 years) minus ₹ 600 (W.N.10) (using new estimate of useful life) = ₹ 900.
10. ₹ 3,000 (W.N.11) carrying amount ÷ 5 years remaining useful life = ₹ 600 depreciation per year.
11. [₹ 6,000 cost minus (₹ 1,500 depreciation x 2 years)] = ₹ 3,000 carrying amount at 31<sup>st</sup> March, 20X2.
12. (₹ 18,000 fair value of investment in associates at 31<sup>st</sup> March, 20X1 minus ₹ 3,000 carrying amount based on the cost model at the same date) x 0.7 (to reflect 30% income tax rate) = ₹ 10,500 (effect of a change in accounting policy (from cost model to fair value model)).
13. ₹ 10,500 (W.N.12) + [₹ 2,000 (W.N.5) x 0.7 (to reflect 30% income tax rate)] = ₹ 11,900.