CHAPTER 4

IND AS ON MEASUREMENT BASED ON ACCOUNTING POLICIES

UNIT 1: INDIAN ACCOUNTING STANDARD 8 : ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Apply the principles laid down for selection of accounting policies.
- Explain the treatment of changes in accounting policies, changes in accounting estimates and correction of prior period errors.
- Distinguish between accounting policies, estimates, changes in them and errors.
- Assess the limitations of giving retrospective effect while accounting.
- Judge the impracticability of a requirement for giving retrospective effect.

UNIT OVERVIEW

Ind AS 8 "Accounting Policies, Changes in Accounting Estimates and Errors"

Accounting Policies

- Selection and application of accounting policies
- Consistency of accounting policies
- Changes in accounting policies
- Applying changes in accounting policies
  - Retrospective application
  - Limitations on retrospective application
- Disclosure

Changes in Accounting Estimates

- Apply changes in accounting estimates prospectively
- Disclosure

Errors

- Limitations on retrospective restatement
- Disclosure of prior period errors

1.1 INTRODUCTION

Ind AS 1, Presentation of Financial Statements, lays down the foundation for an entity regarding how the financial statements need to be presented. Ind AS 1 gives equal importance to the disclosure, in notes, of significant accounting policies and other explanatory information besides balance sheet, statement of profit and loss, statement of changes in equity and statement of cash flows.

Accounting policies, estimates and correction of errors play a major role in the presentation of financial statements. That is why Ind AS 1 states that an entity cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material. If there is any change in accounting policies, that needs to be dealt with due diligence and not just by mere note or explanation.

Further, Ind AS 1 makes it mandatory for the entity to present a third balance sheet as at the beginning of the preceding period, if it applies an accounting policy retrospectively, which has a material effect on the information in the balance sheet at that date.

Further, Ind AS 1 provides detail guidance about the proper disclosure of accounting policies and estimates.

Therefore, in the current chapter we are going to see, how to select the accounting policies, how to make the changes in accounting policies if needed, how to deal with changes in the estimates, how to rectify errors, etc., as all these elements will have impact on the true and fair position of the financial statements.

1.2 OBJECTIVE

1.2.1 To prescribe the criteria for selecting and changing accounting policies

As per Ind AS 1, an entity is required to disclose the significant accounting policies. However, it does not specify which accounting policies are to be disclosed. Depending upon the nature of business and types of transactions, the entity is supposed to decide whether an accounting policy is to be disclosed. In this regard, Ind AS 1 lays emphasis on usefulness of the disclosure in assisting the users in understanding financial statements, nature of an entity's operations and expectations of users. Ind AS 8 further provides some criteria / guidelines which will facilitate the entity to take a decision on selection and application of accounting policies and also making changes in them.

1.2.2 To prescribe the accounting treatment and disclosure of changes in accounting policies

At certain times, there is a need to make the changes in the policies in the light of changing circumstances of business, changing nature of business, new guidelines issued by regulatory authorities, enforcement of new laws etc. In such cases, an entity needs guidance as to whether the changes need to be affected retrospectively or only prospectively and how to present and disclose the effect of the same in the financial statements. Ind AS 8 provides guidance to the entity in such areas.

1.2.3 To prescribe the accounting treatment and disclosure of changes in accounting estimates

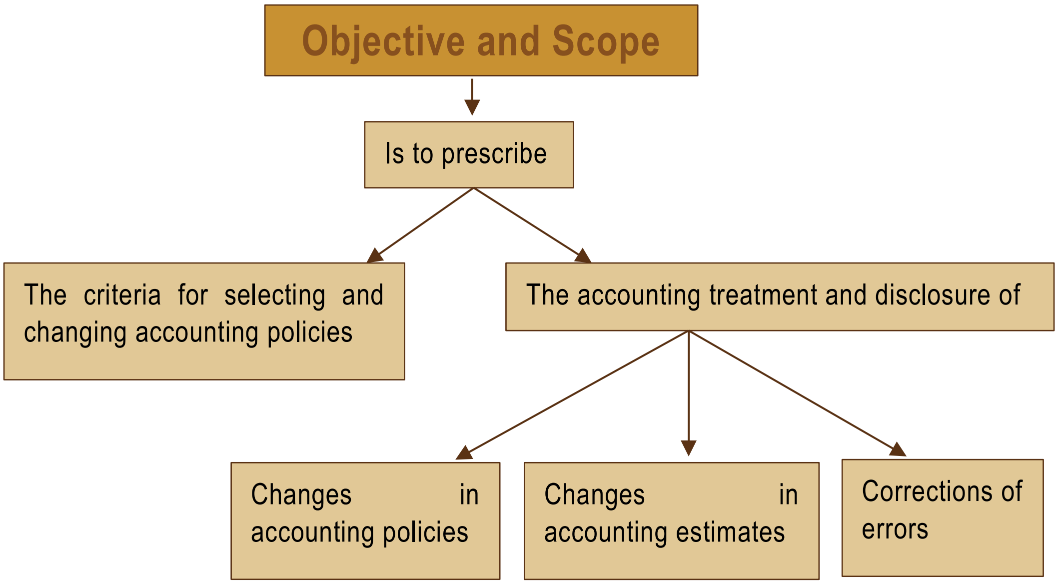
In business, there are many things which are uncertain. For example, how many trade receivables will turn bad? What will be the estimated life of property, plant and equipment? What will be the value of investments? Will the net realisable value of closing inventory be more or less than the actual realised value less actual costs of completion and actual costs necessary to make the sale? And so on. In such cases, the entity will have to make few assumptions and make an estimate. Ind AS 1 allows an entity to do the estimation. Ind AS 8 takes it further and deals with how to incorporate the changes in the accounting estimates already made in the past. Is it possible to change such estimates with changing circumstances and available new information? If yes, how would the entity incorporate the effect of the changes? Such questions are addressed in Ind AS 8.

1.2.4 To prescribe the accounting treatment and disclosure of corrections of errors

It is said that 'to err is human'. Making mistakes is an integral part of life and the possibility of having some errors in the financial statements already published cannot be ruled out. In such cases, the question arises as to how to rectify the errors and provide the true and fair position to the stakeholders of financial statements. Should the entity rectify the error by way of retrospective restatement or should it rectify the same in the current reporting period? Such questions are addressed in Ind AS 8.

1.2.5 To provide better base for inter-firm and intra-firm comparison

The standard is intended to enhance the relevance and reliability of an entity's financial statements and the comparability of those financial statements over time and with the financial statements of other entities.



1.3 SCOPE

This standard shall be applied in

- selecting and applying accounting policies;
- accounting for changes in accounting policies;
- accounting for changes in accounting estimates; and
- accounting for corrections of prior period errors.

However, tax effects of retrospective application of accounting policy changes and correction of prior period errors are not dealt with in this standard. The tax effects of these items are dealt with Ind AS 12, 'Income Taxes'.

Note: Requirements of Ind AS 8 in respect of changes in accounting policies do not apply in an entity's first Ind AS financial statements.

1.4 DEFINITIONS

1. ***Accounting policies*** are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

2. ***Accounting estimates*** are monetary amounts in financial statements that are subject to measurement uncertainty.

3. ***Indian Accounting Standards (Ind AS)*** are Standards prescribed under Section 133 of the Companies Act, 2013 read with Companies (Indian Accounting Standards) Rules, 2015 (as amended from time to time).

4. ***Material –*** (As per Ind AS 1) Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.

   Materiality depends on the nature or magnitude of information, or both. An entity assesses whether information, either individually or in combination with other information, is material in the context of its financial statements taken as a whole.

   Information is obscured if it is communicated in a way that would have a similar effect for primary users of financial statements to omitting or misstating that information. The following are examples of circumstances that may result in material information being obscured:

   (a) information regarding a material item, transaction or other event is disclosed in the financial statements but the language used is vague or unclear;

   (b) information regarding a material item, transaction or other event is scattered throughout the financial statements;

   (c) dissimilar items, transactions or other events are inappropriately aggregated;

   (d) similar items, transactions or other events are inappropriately disaggregated; and

   (e) the understandability of the financial statements is reduced as a result of material information being hidden by immaterial information to the extent that a primary user is unable to determine what information is material.

   Assessing whether information could reasonably be expected to influence decisions made by the primary users of a specific reporting entity‘s general purpose financial statements requires an entity to consider the characteristics of those users while also considering the entity's own circumstances.

Many existing and potential investors, lenders and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial statements for much of the financial information they need. Consequently, they are the primary users to whom general purpose financial statements are directed. Financial statements are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. At times, even well informed and diligent users may need to seek the aid of an adviser to understand information about complex economic phenomena.

The application of the concept of materiality is set out in two Standards. Ind AS 1 continues to specify its application to disclosures and Ind AS 8 specifies the application of materiality in applying accounting policies and correcting errors (including errors in measuring items).

5. ***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.

6. ***Retrospective application*** is applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied.

7. ***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.

8. ***Impracticable:*** Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. For a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if:

(a) the effects of the retrospective application or retrospective restatement are not determinable;

(b) the retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period; or

(c) the retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:

(i) provides evidence of circumstances that existed on the date(s)as at which those amounts are to be recognised, measured or disclosed; and

(ii) would have been available when the financial statements for that prior period were approved for issue from other information.

9. ***Prospective application*** of a change in accounting policy and of recognising 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) recognising the effect of the change in the accounting estimate in the current and future periods affected by the change.

1.5 ACCOUNTING POLICIES

1.5.1 Selection and application of accounting policies

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

Ind AS 1 narrates the importance of accounting policies but Ind AS 8 goes a step further and gives guidance to the entity as to how to select and apply accounting policies.

Let us take few examples of accounting policies:

(a) Basis of accounting – Cash or accrual or hybrid?

(b) Method of determination of cost of inventories – FIFO or specific identification or Weighted Average?

(c) What is included in cash equivalents and what is excluded from cash equivalents?

(d) When should revenue be recognised?

Thus, one will notice that while preparing the financial statements, the entity has to make numerous assumptions and define the base for measurement of particular transactions, other events or conditions. If every entity follows a different base or a different rule or a different convention according to their convenience/ interpretation, then it will be impossible to compare the financial statements across entities having similar nature of business. Therefore, the role of Ind AS is very important in selection and application of the policies.

As per Ind AS 8, if any of the Ind AS already specifies the guidelines about following a particular policy then entity **must** follow that standard and apply the policy as per the guidance provided. Moreover, an entity can also refer to guidance notes which are published by ICAI, along with the relevant Ind AS, if there is an ambiguity or there is need to go into the depth of a particular transaction.

1.5.2 Is it compulsory to apply accounting policies?

- Ind AS set out accounting policies that result in financial statements containing relevant and reliable information about the transactions, other events and conditions to which they apply.
- Those policies need not be applied when the effect of applying them is immaterial.
- However, it is inappropriate to make, or leave uncorrected, immaterial departures from Ind AS to achieve a particular presentation of an entity's financial position, financial performance or cash flows.

Analysis

Ind AS leaves the judgement to the entity to decide whether it would be material or not material to apply any accounting policy. Users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence. Therefore, the assessment needs to take into account how users with such attributes could reasonably be expected to be influenced in making economic decisions.

1.5.3 How to select and apply an accounting policy when specific Ind AS is not available on the particular transaction / condition / event?

- In the absence of an Ind AS that specifically applies to a transaction, other event or condition, management shall use its judgement 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.

Analysis

The businesses may have large variety of transactions in terms of their nature and size. Though Ind AS cover most of the transactions which are of general nature for any type of business, there is possibility of new business models coming into picture and new technologies changing the face of the business, resulting in some new and complex types of transactions. In such circumstances it will be difficult to find the appropriate accounting standard for such specific transactions.

Example 1

Before the wake of online transactions of capital markets, the trading of shares used to take place mainly through brokers and stock exchanges. However, OTC online terminals changed the face of the capital markets, giving direct access to the layman to trading transactions. Even if the basic nature of business was same, the technology changed the face of the business, and many giant financial institutions became the dominant players in the market as brokerage firms. In view of the changing circumstances, SEBI and ICAI have come up with new guidelines and new standards which will cater to the need of new business models, such as trading in derivatives. However, there was a period of transformation when new transactions were slowly creeping in, but the guidelines were in the preparatory phase.

In such circumstances, Ind AS 8 provides the following guiding principles for selecting and applying the accounting policies. The main two objectives to be kept in mind while making the decision for selecting an accounting policy would be:

(i) **Whether it is relevant?** The basic purpose of presenting financial statements is to facilitate the economic decision making of the stakeholders, which would be based on the information provided in the financial statements. So, if the management is of the opinion that an accounting policy related to a particular transaction/ condition / event results in information that is going to help the users to make the economic decisions, then the entity must select and apply such accounting policy as it is relevant for decision making.

(ii) **Whether it is reliable?** The information will be said to be reliable if it makes a faithful representation, unbiased, prudent, complete in all material respects and it reflects substance of the transaction and is not presented solely with a purpose of adhering to the law.

- In making the judgement, management shall refer to, and consider the applicability of, the following sources in descending order:

  (a) the requirements in Ind AS dealing with similar and related issues; and

  (b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Conceptual Framework for Financial Reporting under Indian Accounting Standards (Conceptual Framework).

- Management may also first consider the most recent pronouncements of International Accounting Standards Board (IASB) and in absence thereof those of the 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 sources mentioned above.

Analysis

There is a need to have some authentic base for selecting and applying the accounting policy. Even if it is left to the judgement of the entity, there has to be some basis for making the judgement. It cannot be left to the personal opinions/ understanding/ intuitions of the people working for the entity. In view of this, Ind AS 8 requires that in absence of specific Ind AS, the entity should refer to the following material, in their descending order. Accordingly, Ind AS 8 provides the following list:

(i) Check if there are any other Ind AS available which are dealing with **similar and related** issues

(ii) Check the basic Conceptual Framework of Ind AS, which provides the general principles

(iii) Check the pronouncements of International Accounting Standard Board

(iv) Check the pronouncements of other standard setting bodies having a similar conceptual framework

(v) Check the accounting literature and accepted industry practices.

1.5.4 Consistency of accounting policies

An entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions, unless an Ind AS specifically requires or permits categorisation of items for which different policies may be appropriate. If an Ind AS requires or permits such categorisation, an appropriate accounting policy shall be selected and applied consistently to each category.

Analysis

Accounting policies are the bases or principles or conventions or rules which are followed by an entity while preparing the financial statements. If the entity keeps on changing the base from year to year, it will not reflect the true and fair financial position of the entity. Secondly the results of earlier years cannot be compared with the latest year as the base of the measurement is changed. Therefore, it is utmost necessity that the entity follows the accounting policies consistently.

Examples 2 & 3

2. An entity has grouped its property, plant and equipment into four classes viz., land, factory building, plant and machinery and furniture. The entity may propose to apply revaluation model only to land. It need not apply this model to building or plant and machinery.

3. Ind AS 2 'Inventories' requires that inventory be valued at lower of cost and net realizable value. In identifying cost, it allows alternative cost formulas; FIFO and Weighted average. The same cost formula must be applied to items of inventory having similar nature or use, but a different cost formula can be applied to a different classification of inventory.

1.5.5 Changes in accounting policies

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

  (a) is required by an Ind AS; 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.

Example 4 - Voluntary change in accounting policy

As per Ind AS 27 'Separate Financial Statements', investment in subsidiaries, associates and joint ventures are accounted for in an entity's separate financial statements at cost or in accordance with Ind AS 109 (i.e., at fair value). The same accounting is required to be applied for each category of investment.

Assume that an entity decides to change its policy of measuring investment in subsidiaries (or associates or joint ventures) from cost to fair value in accordance with Ind AS 109, as this will result in the financial statements providing reliable and more relevant information.

This would constitute a voluntary change in accounting policy.

- Users of financial statements need to be able to compare the financial statements of an entity over time to identify trends in its financial position, financial performance and cash flows. Therefore, the same accounting policies are applied within each period and from one period to the next unless a change in accounting policy meets one of the above criteria.

Analysis

Continuing with the same rationale, the frequent changes in accounting policies are not permitted by Ind AS 8. Frequent changes in accounting policies will make it impossible for a stakeholder to make the economic decisions properly.

For example, suppose an entity has been following the FIFO method of determination of cost for inventories. In the current year, it shifts from FIFO to weighted average method. Assuming that cost is less than NRV, it means the opening stock is valued at FIFO method whereas closing stock is valued at Weighted Average Method, if retrospective application of the change is impracticable. This will directly impact the gross profit measurement of the entity. Additionally, the opening inventories and closing inventories will not be comparable.

Moreover, if the investment companies and banks are using the information for calculation of liquidity, then, the liquidity ratios based on opening inventory and closing inventory may show major discrepancies. Thus, changing the base will not only affect the true and fair position of the financial statements but it will also affect the decision making of the stakeholders.

In view of the above, Ind AS 8 allows the entity to change the accounting policy only in following circumstances:

(a) when the change is required by an Ind AS; or

(b) when the change 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.

Analysis

Ind AS 8 clearly states that if the entity applies an accounting policy which is different from the previous one to a transaction, other event or condition that differs in substance from a previously occurring transaction, other event or condition, the application of the new policy will not be considered as a change in accounting policy.

Example 5

A company owns several hotels and provides significant ancillary services to occupants of rooms. These hotels are, therefore, treated as owner-occupied properties and classified as property, plant and equipment in accordance with Ind AS 16. The company acquires a new hotel but outsources entire management of the same to an outside agency and remains as a passive investor. The selection and application of an accounting policy for this new hotel in line with Ind AS 40 is not a change in accounting policy simply because the new hotel rooms are also let out for rent. This is because the way in which the new hotel is managed differs in substance from the way other existing hotels have been managed so far.

Similarly, if an entity is not applying the accounting policy currently and starts applying the accounting policy newly, that will also not be treated as a change in accounting policy.

Example 6

An entity has classified as investment property, an owner-occupied property previously classified as part of property, plant and equipment where it was measured after initial recognition applying the revaluation model. Ind AS 40 on investment property permits only cost model. The entity now measures this investment property using the cost model. This is not a change in accounting policy.

- The initial application of a policy to revalue assets in accordance with Ind AS 16 'Property, Plant and Equipment', or Ind AS 38 'Intangible Assets', is a change in an accounting policy to be dealt with as a revaluation in accordance with Ind AS 16 or Ind AS 38, rather than in accordance with Ind AS 8.
- As per Ind AS 16, a change in depreciation method should be accounted for as a change in accounting estimate in accordance with Ind AS 8. Similarly, as per Ind AS 38, a change in amortisation method should be accounted for as a change in accounting estimate in accordance with Ind AS 8. These changes are, therefore, not changes in accounting policies.

Illustration 1

Can an entity voluntarily change one or more of its accounting policies?

Solution

A change in an accounting policy can be made only if the change is required or permitted by Ind AS 8.

As per para 14 of Ind AS 8, an entity shall change an accounting policy only if the change:

(a) is required by an Ind AS; 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.

Para 15 of the standard states that the users of financial statements need to be able to compare the financial statements of an entity over time to identify trends in its financial position, financial performance and cash flows. Therefore, the same accounting policies are applied within each period and from one period to the next unless a change in accounting policy meets one of the above criteria.

Paragraph 14(b) lays down two requirements that must be complied with in order to make a voluntary change in an accounting policy. First, the information resulting from application of the changed (i.e., the new) accounting policy must be reliable. Second, the changed accounting policy must result in "more relevant" information being presented in the financial statements.

Whether a changed accounting policy results in reliable and more relevant financial information is a matter of assessment in the particular facts and circumstances of each case. In order to ensure that such an assessment is made judiciously (such that a voluntary change in an accounting policy does not effectively become a matter of free choice), paragraph 29 of Ind AS 8 requires an entity making a voluntary change in an accounting policy to disclose, inter alia, "the reasons why applying the new accounting policy provides reliable and more relevant information."

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Illustration 2

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?

Solution

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.

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Illustration 3

Whether change in functional currency of an entity represents a change in accounting policy?

Solution

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 21, 'functional currency' is the currency of the primary economic environment in which the entity operates.

Paragraphs 9-12 of Ind AS 21 list factors to be considered by an entity in determining its functional currency. It is recognised that there may be cases where the functional currency is not obvious. In such cases, Ind AS 21 requires the management to use its judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions.

Paragraph 13 of Ind AS 21 specifically notes that an entity's functional currency reflects the underlying transactions, events and conditions that are relevant to it. Accordingly, once determined, the functional currency is not changed unless there is a change in those underlying transactions, events and conditions. Thus, functional currency of an entity is not a matter of an accounting policy choice.

In view of the above, a change in functional currency of an entity does not represent a change in accounting policy and Ind AS 8, therefore, does not apply to such a change. Ind AS 21 requires that when there is a change in an entity's functional currency, the entity shall apply the translation procedures applicable to the new functional currency prospectively from the date of the change.

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1.5.5.1 How to apply the changes in accounting policies?

While discussing the process for application of changes of accounting policies, Ind AS 8, deals with two situations:

1. An entity shall account for a change in accounting policy resulting from the initial application of an Ind AS in accordance with the specific transitional provisions, if any, in that Ind AS.

   If a change in accounting policy is due to a new Ind AS, then, generally the standard itself provides the transitional provisions i.e., provisions applicable on initial application of the standard, such as method of application (retrospective or prospective or modified retrospective), availability of any transitional relief etc. In such cases, the entity needs to follow the transitional provisions accordingly.

2. When an entity changes an accounting policy upon initial application of an Ind AS that does not include specific transitional provisions applying to that change, or changes an accounting policy voluntarily, it shall apply the change retrospectively.

   If the change in accounting policy is made voluntarily or where the Ind AS is not containing transitional provisions, then the accounting policy needs to be applied retrospectively.

Note: Early application of an Ind AS is not a voluntary change in accounting policy.

In the absence of an Ind AS that specifically applies to a transaction, other event or condition, management may apply an accounting policy from the most recent pronouncements of IASB and in absence thereof those of the other standard-setting bodies that use a similar conceptual framework to develop accounting standards.

If, following an amendment of such a pronouncement, the entity chooses to change an accounting policy, that change is accounted for and disclosed as a voluntary change in accounting policy.

Suppose in absence of any specific Ind AS to a particular transaction, a company follows an accounting policy as per the relevant IFRS which addresses that transaction and, subsequently there is an amendment to that IFRS, then, the company may change its accounting policy as per that amendment. In such cases, it will be considered as if the company is making the change voluntarily and, accordingly, change in the accounting policy should be applied retrospectively.

Illustration 4

An entity developed one of its accounting policies by considering a pronouncement of an overseas national standard-setting body in accordance with Ind AS 8. Would it be permissible for the entity to change the said policy to reflect a subsequent amendment in that pronouncement?

Solution

In the absence of an Ind AS that specifically applies to a transaction, other event or condition, management may apply an accounting policy from the most recent pronouncements of International Accounting Standards Board and in absence thereof those of the other standard-setting bodies that use a similar conceptual framework to develop accounting standards. If, following an amendment of such a pronouncement, the entity chooses to change an accounting policy, that change is accounted for and disclosed as a voluntary change in accounting policy. As such a change is a voluntary change in accounting policy, it can be made only if it results in information that is reliable and more relevant (and does not conflict with the sources in Ind AS 8).

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1.5.5.2 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.

Analysis

The word retrospective application is defined in Ind AS 8 as applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied. This means that comparative information for all prior periods presented will be adjusted for the effect of change in the policy. The amount of the resulting adjustment relating to periods before those presented in the financial statements is made to the opening balance of each affected component of equity of the earliest prior period presented. Usually the adjustment is made to retained earnings. However, the adjustment may be made to another component of equity (for example, to comply with an Ind AS).

Example 7

An entity which is trading in goods (and not a manufacturer) was incorporated in the year 20X1-20X2 and is a regular user of Ind AS from that year. It has been using weighted average cost formula for determining cost of inventories. In 20X8-20X9, it decides to change the above accounting policy. It wants to use FIFO cost formula. The change in the policy is justified because that formula reflects the actual flow of inventories and, hence, provides reliable and more relevant information to the users of financial statements. The entity presents one year comparative period in its financial statements. Its purchase bills include freight etc., and quantities of inventories as on 1st April, 20X7 and 31st March, 20X8 are such that latest invoices for the relevant years can be attributed to them. Further, other purchase incidental expenses are immaterial. Due to these reasons, retrospective application of change in accounting policy is practicable.

The entity trades in goods, both purchases of stock-in-trade and increase/decrease in inventories of stock-in-trade will appear in the statement of profit and loss. This is because Ind AS 1 permits nature-wise presentation only, which is also the position in Schedule III to the Companies Act, 2013. The change in accounting policy, however, will affect only the carrying amount of inventories and consequently, increase/decrease in inventories, if cost is below NRV, but will not affect amount of purchases.

In the above situation, the entity should apply the change in the accounting policy retrospectively. For this purpose, the entity should recalculate inventory value at the lower of cost determined on FIFO basis and NRV as at 1st April, 20X7 and 31st March, 20X8. The difference between previously presented opening inventory value as at 1st April, 20X7 (which would have been presented in the balance sheet as at 31st March, 20X7) and the recalculated value as on that date as above is the cumulative effect of change in accounting policy on the opening balance sheet for the comparative year 20X7-20X8. The difference between previously presented closing inventory value as at 31st March, 20X8 and the recalculated value as on that date as above is the cumulative effect of change in accounting policy on the closing balance sheet for the comparative year 20X7-20X8. The difference between the cumulative effects on the opening and closing balance sheets for the comparative year 20X7-20X8 as arrived at above is the period-specific effect of change in the policy for that comparative year. Accordingly, while preparing the financial statements for the year 20X8-20X9, the entity should adjust the opening inventory as at 1st April, 20X7 and adjust retained earnings on that date for the cumulative effect of change in accounting policy and restate comparative amount in respect of increase/decrease in inventories in the statement of profit and loss for the comparative year 20X7-20X8. This results in consequential restatement of profit or loss, total comprehensive income, closing balances of retained earnings and inventories for that comparative year. The said restated closing balances of retained earnings and inventories become opening balances of these items for the year 20X8-20X9, which is the year of change in accounting policy. Income tax effect due to change in accounting policy will be accounted for in accordance with Ind AS 12.

1.5.5.3 Limitations on retrospective application

- The intention of the standard is, as far as possible, that the companies should follow the same accounting policies consistently year after year to ensure the relevance and reliability of financial statements.
- There are some advantages of making the process of change in accounting policy so tedious as outlined below.
  - (i) Companies will not make the frequent changes in their accounting policies just to do the window dressing of their financial statements.
  - (ii) The comparison of financial statements over time and with other entities will be possible, in a reliable way.
- Having said this, there can be practical difficulties in making the retrospective changes in policies, when the company wants to change the policy.

Example 8

A company has been incorporated 25 years ago and since then doing the business on pan India basis. Now, is it supposed to incorporate the changes in accounting policy for last 25 years? Will it be practicable? Will it be worth doing it? Will it be material? Such questions arise when one wants to change the accounting policy, since voluntary change in policy is required to be applied retrospectively.

- When retrospective application is required, a change in accounting policy shall be applied retrospectively except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the change.
- The term 'Impracticability' is defined under Ind AS 8 as follows:

  Impracticable - Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. For a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if:

(a) the effects of the retrospective application or retrospective restatement are not determinable;

(b) the retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period; or

(c) the retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:

   (i) provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosed; and

   (ii) would have been available when the financial statements for that prior period were approved for issue from other information.

- After going through the above-mentioned definition of impractical, it is clear that the Ind AS 8 does provide some relief if there are practical difficulties in applying the policy retrospectively.

- Ind AS 8 talks about two types of effects which one need to understand:

  (i) Period Specific: Period specific means for each financial year.

  (ii) Cumulative: Cumulative is the sum total of the period specific effects.

- When it is impracticable to determine the period-specific effects of changing an accounting policy on comparative information for one or more prior periods presented, then the entity shall apply the new accounting policy to the carrying amounts of assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable, which may be the current period, and shall make a corresponding adjustment to the opening balance of each affected component of equity for that period.

- Thus, if it is impracticable for an entity to change the policy from day 1, because it is impracticable to determine period-specific effects for one or more comparative prior periods presented, it can apply the changed policy from the earliest period for which it would be practicable to make the changes in policies retrospectively which may be the current period.

Example 9

In the example given in the section 1.5.5.2 above, if comparative information is presented for two years i.e., 20X6-20X7 and 20X7-20X8 and if it is not practicable to apply the changed policy retrospectively from 20X6-20X7, then, the entity can apply the changed policy retrospectively from 20X7-20X8. This may happen if it is not practicable to compute the inventory value in accordance with the changed policy as on 1st April, 20X6, for example, due to loss of latest purchase bills for the year 20X5-20X6 and computer records of the same are also lost.

In the above example, if comparative information is presented for one year and if it is not practicable to compute the opening inventory value as at 1st April, 20X7, the entity can apply the changed policy retrospectively from 20X8-20X9.

- When an entity applies a new accounting policy retrospectively, it applies the new accounting policy to comparative information for prior periods as far back as is practicable. Retrospective application to a prior period is not practicable unless it is practicable to determine the cumulative effect on the amounts in both the opening and closing balance sheets for that period. The amount of the resulting adjustment relating to periods before those presented in the financial statements is made to the opening balance of each affected component of equity of the earliest prior period presented. Usually, the adjustment is made to retained earnings. However, the adjustment may be made to another component of equity (for example, to comply with an Ind AS). Any other information about prior periods, such as historical summaries of financial data, is also adjusted as far back as is practicable.

- When it is impracticable to determine the cumulative effect, at the beginning of the current period, of applying a new accounting policy to all prior periods, the entity shall adjust the comparative information to apply the new accounting policy prospectively from the earliest date practicable. It therefore disregards the portion of the cumulative adjustment to assets, liabilities and equity arising before that date. Changing an accounting policy is permitted even if it is impracticable to apply the policy retrospectively for any prior period.

Example 10

In 20X6, an entity changes its accounting policy with respect to determination of cost of its inventories from FIFO to weighted average cost formula. This change is made because management believes that weighted average cost formula results in better matching of cost with revenue. Further, weighted average cost formula is generally used by other entities whose business is similar to that of the entity and, hence, provides reliable and more relevant information to the users of the financial statements. This being a voluntary change, it has to be applied retrospectively. The entity had commenced operations in 20X1. No records of earlier years are available as a virus attack on server in 20X6 had wiped off all past records. It is not possible to recreate the records. It is therefore impracticable to determine the cumulative effect of change in policy at the beginning of 20X6. The entity will apply the change in accounting policy prospectively from 20X6 only. Since the change in policy is applied prospectively from 20X6, the question of adjusting comparative information for any prior period(s) presented does not arise at all. Cost of closing inventories for 20X6 alone will be determined using weighted average cost formula. The carrying amount of closing inventories for 20X5 will simply be carried as carrying amount of opening inventories for 20X6. Cost of closing inventories for 20X5 determined on FIFO basis will be the starting point for applying weighted average cost formula during 20X6.

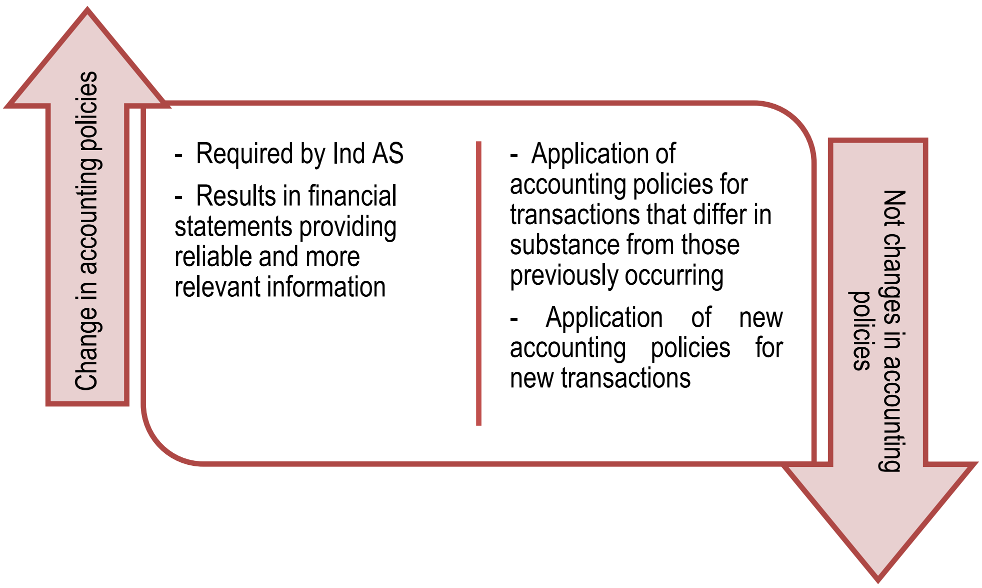

Illustration 5

Whether an entity can change its accounting policy of subsequent measurement of property, plant and equipment (PPE) from revaluation model to cost model?

Solution

Paragraph 29 of Ind AS 16 provides that an entity shall choose either the cost model or the revaluation model as its accounting policy for subsequent measurement of an entire class of PPE.

A change from revaluation model to cost model for a class of PPE can be made only if it meets the condition specified in Ind AS 8 paragraph 14(b) i.e. the change results in the financial statements providing reliable and more relevant information to the users of financial statements. For example, an unlisted entity planning IPO may change its accounting policy from revaluation model to cost model for some or all classes of PPE to align the entity's accounting policy with that of listed markets participants within that industry so as to enhance the comparability of its financial statements with those of other listed market participants within the industry. Such a change – from revaluation model to cost model is not expected to be frequent.

Where the change in accounting policy from revaluation model to cost model is considered permissible in accordance with Ind AS 8 paragraph 14(b), it shall be accounted for retrospectively, in accordance with Ind AS 8.

*****

1.5.6 Disclosure regarding the changes in accounting policies

- When initial application of an Ind AS has an effect on the current period or any prior period, would have such an effect except that it is impracticable to determine the amount of the adjustment, or might have an effect on future periods, an entity shall disclose:

  (a) the title of the Ind AS;

  (b) when applicable, that the change in accounting policy is made in accordance with its transitional provisions;

  (c) the nature of the change in accounting policy;

  (d) when applicable, a description of the transitional provisions;

  (e) when applicable, the transitional provisions that might have an effect on future periods;

  (f) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:

    (i) for each financial statement line item affected; and

(ii) if Ind AS 33, 'Earnings per Share', applies to the entity, for basic and diluted earnings per share;

(g) the amount of the adjustment relating to periods before those presented, to the extent practicable; and

(h) if retrospective application required by paragraph 19(a) or (b) of Ind AS 8 is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

- When a voluntary change in accounting policy has an effect on the current period or any prior period, would have an effect on that period except that it is impracticable to determine the amount of the adjustment, or might have an effect on future periods, an entity shall disclose:

(a) the nature of the change in accounting policy;

(b) the reasons why applying the new accounting policy provides reliable and more relevant information;

(c) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:

(i) for each financial statement line item affected; and

(ii) if Ind AS 33 applies to the entity, for basic and diluted earnings per share;

(d) the amount of the adjustment relating to periods before those presented, to the extent practicable; and

(e) if retrospective application is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

Note:

- Financial statements of subsequent periods need not repeat these disclosures.
- These disclosures will form part of Notes to Accounts.

- When an entity has not applied a new Ind AS that has been issued but is not yet effective, the entity shall disclose:

(a) this fact; and

(b) known or reasonably estimable information relevant to assessing the possible impact that application of the new Ind AS will have on the entity's financial statements in the period of initial application.

- In complying with the above requirement, an entity considers disclosing:

  (a) the title of the new Ind AS;

  (b) the nature of the impending change or changes in accounting policy;

  (c) the date by which application of the Ind AS is required;

  (d) the date as at which it plans to apply the Ind AS initially;

  (e) either:

  (i) a discussion of the impact that initial application of the Ind AS is expected to have on the entity's financial statements; or

  (ii) if that impact is not known or reasonably estimable, a statement to that effect.

Illustration 6

Whether an entity is required to disclose the impact of any new Ind AS which is issued but not yet effective in its financial statements as per Ind AS 8?

Solution

Paragraph 30 of Ind AS 8 Accounting Policies, Changes in Accounting Estimates and Errors, states as follows:

"When an entity has not applied a new Ind AS that has been issued but is not yet effective, the entity shall disclose:

(a) this fact; and

(b) known or reasonably estimable information relevant to assessing the possible impact that application of the new Ind AS will have on the entity's financial statements in the period of initial application."

Accordingly, it may be noted that an entity is required to disclose the impact of Ind AS which has been issued but is not yet effective.

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1.6 CHANGE IN ACCOUNTING ESTIMATES

1.6.1 Meaning

- An accounting policy may require items in financial statements to be measured in a way that involves measurement uncertainty — that is, the accounting policy may require such items to be measured at monetary amounts that cannot be observed directly and must instead be estimated. In such a case, an entity develops an accounting estimate to achieve the objective set out by the accounting policy. Developing accounting estimates involves the use of judgements or assumptions based on the latest available, reliable information. Examples of accounting estimates include:

  (a) a loss allowance for expected credit losses, applying Ind AS 109, Financial Instruments;

  (b) the net realisable value of an item of inventory, applying Ind AS 2 Inventories;

  (c) the fair value of an asset or liability, applying Ind AS 113, Fair Value Measurement;

  (d) the depreciation expense for an item of property, plant and equipment, applying Ind AS 16; and

  (e) a provision for warranty obligations, applying Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets.

- An entity uses measurement techniques and inputs to develop an accounting estimate. Measurement techniques include estimation techniques (for example, techniques used to measure a loss allowance for expected credit losses applying Ind AS 109) and valuation techniques (for example, techniques used to measure the fair value of an asset or liability applying Ind AS 113).

- The term ‘estimate’ in Ind AS sometimes refers to an estimate that is not an accounting estimate as defined in this Standard. For example, it sometimes refers to an input used in developing accounting estimates.

- The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

1.6.2 Can changes in estimates be related to prior periods?

- An entity may need to change an accounting estimate if changes occur in the circumstances on which the accounting estimate was based or as a result of new information, new developments or more experience.
- By its nature, a change in an accounting estimate does not relate to prior periods and is not the correction of an error.
- The effects on an accounting estimate of a change in an input or a change in a measurement technique are changes in accounting estimates unless they result from the correction of prior period errors.

1.6.3 Change in the basis of measurement – Whether a change in accounting policy or change in estimate?

A change in the measurement basis applied is a change in an accounting policy and is not a change in an accounting estimate. 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.

Illustration 7

Whether a change in inventory cost formula is a change in accounting policy or a change in accounting estimate?

Solution

As per Ind AS 8, accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements. Further, paragraph 36(a) of Ind AS 2, 'Inventories', specifically requires disclosure of 'cost formula used' as a part of disclosure of accounting policies adopted in measurement of inventories.

Accordingly, a change in cost formula is a change in accounting policy.

*****

1.6.4 Accounting treatment for applying changes in accounting estimates

- The effect of change in an accounting estimate, except to the extent that the change results in change in assets, liabilities or relates to an item of equity, 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.

  A change in an accounting estimate may affect only the current period's profit or loss, or the profit or loss of both the current period and future periods.

- 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 recognised by adjusting the carrying amount of the related asset, liability or equity item in the period of the change.

- Prospective recognition of the effect of a change in an accounting estimate means that the change is applied to transactions, other events and conditions from the date of that change. A change in an accounting estimate may affect only the current period's profit or loss, or the profit or loss of both the current period and future periods. For example, a change in a loss allowance for expected credit losses affects only the current period's profit or loss and therefore is recognised in the current period. However, a change in the estimated useful life of, or the expected pattern of consumption of the future economic benefits embodied in, a depreciable asset affects depreciation expense for the current period and for each future period during the asset's remaining useful life. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods is recognised as income or expense in those future periods.

Relevant extract from Annual Report of Indus Towers Limited for Financial Year 2020-2021 on change in accounting estimates

The Company has revised the useful life of property, plant and equipment and useful life and estimation of ARO and taken the impact prospectively from the date of change.

During the period ended March 31, 2021, the Company has revised the useful life of civil work included in Plant and machinery from 15 years to 20 years with effect from December 1, 2020. Set out below is impact of such change on future period depreciation:

Particulars	Year ended March 31, 2021	Year ended March 31, 2022
Decrease in Depreciation	405	1043

Further, the Company has also reassessed useful life from 15 years to 20 years and estimate of dismantling obligation for Asset retirement obligation w.e.f. December 1, 2020 and has taken the credit of ₹ 184 Mn in the Statement of Profit and Loss.

Examples 11 and 12

11. A change in the estimate of the amount of bad debts affects only the current period's profit or loss and therefore is recognised in the current period. However, a change in the estimated useful life of, or the expected pattern of consumption of the future economic benefits embodied in, a depreciable asset affects depreciation expense for the current period and for each future period during the asset's remaining useful life. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods is to be recognised as income or expense in those future periods.

12. During the financial year ended 31st March, 20X2, Entity ABC introduced a new range of electric motors. It sold the motors with a standard warranty of two years. Warranty provides assurance that a product will function as expected and in accordance with certain specifications and it has been assessed that it is not a separate performance obligation under Ind AS 115.

    Based on results of testing of the motors during trials prior to commercial production, Entity ABC made a provision for warranty costs amounting to ₹ 1,00,000 for motors sold during the year ended 31st March, 20X2.

During financial year 20X2-20X3, a defect was discovered in the motors that had not come to light during the trials. The defect resulted in the entity incurring an amount of ₹ 2,00,000 during the financial year 20X2-20X3 on repairs of motors sold during the financial year 20X1-20X2. Besides, the entity expects to incur ₹ 1,50,000 as costs during the year 20X3-20X4 on meeting its warranty obligations in respect of motors sold during the financial year 20X2-20X3.

In preparing its financial statements for the year ended 31st March, 20X3, the entity would carry forward a warranty provision of ₹ 1,50,000 in respect of motors sold during the financial year 20X1-20X2. It would recognise an amount of ₹ 2,50,000 (₹ 2,00,000 plus ₹ 1,50,000 minus ₹ 1,00,000) in respect of motors sold during the financial year 20X1-20X2 as an expense in profit or loss for the financial year 20X2-20X3. The warranty provision included in the comparatives for financial year ended 31st March, 20X2 would not be adjusted.

The provision for warranty costs in respect of motors sold during the financial year 20X2-20X3 would be made by considering the information concerning the defect in motors that came to light during the financial year 20X2-20X3.

1.6.5 Disclosure of changes in estimates

- An entity shall disclose the nature and amount of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods, except for the disclosure of the effect on future periods when it is impracticable to estimate that effect.
- If the amount of the effect in future periods is not disclosed because estimating it is impracticable, an entity shall disclose that fact.

Thus, to summarise the above-mentioned provisions, the entity should disclose:

(a) Effect of change in estimate on the current period

(b) If applicable and practicable, effect of change in estimate on the future periods

(c) If applicable but impracticable, the fact that it is impracticable to estimate the effect on future periods.

1.7 ERRORS

1.7.1 Meaning

- Ind AS 8 deals with the treatment of errors that have taken place in past but were not discovered at that time. Subsequently, when they are discovered, it is necessary to correct such errors in the financial statements and make sure that the financial statements present relevant and reliable information in the period in which they are discovered.

  As per the definition given in Ind AS 8, ***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.

- Errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements. Financial statements do not comply with Ind AS if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows.

1.7.2 Common types of errors

(i) **Mathematical Mistakes:** In accounting terms, generally the errors are called as error of commission. Wrong calculations, carry forward of wrong balances and errors in totals are few examples of mathematical errors.

(ii) **Mistakes in applying policies:** Specific standards may prescribe method of applying specific policies for particular nature of transaction. For example, as a general rule, assets and liabilities and income and expenses should not be offset, unless otherwise specifically required or permitted in an Ind AS. If a receivable from another entity and payable to that entity are offset without any currently existing legally enforceable right to set off the recognised amounts, then, it will be an error while applying the policies, since it is against the principles of offset prescribed in Ind AS 32, 'Financial Instruments: Presentation'.

(iii) **Misinterpretations of facts:** Ind AS 10 deals with treatment of the events after the reporting period. Whether the event is an adjusting event or a non-adjusting event depends on whether that event provides evidence of a condition existing at the end of the reporting period. Sometimes, this requires judgement of the management and may result into misinterpretation of facts, if not dealt with properly.

(iv) **Omissions:** The mistakes that happened due to omission to record a material transaction, perhaps, due to oversight.

(v) **Frauds:** Major theft undetected in the past.

The abovementioned errors and any other error may happen while recognising the transaction, or while measuring the transaction, or while presenting it in financial statements or it might be possible that proper disclosure is not done.

Example 13

The following errors occurred in preparation of A Ltd.'s financial statements for the immediately preceding financial year –

(a) Depreciation on plant and machinery understated by an amount equal to 0.30% of sales;

(b) Warranty provisions understated by an amount equal to 0.15% of sales;

(c) Allowance for bad debts understated by an amount of 0.25% of sales.

Individually none of these errors may be material but could collectively influence the economic decision of the users of the financial statements. These are material prior period errors.

1.7.3 Treatment of errors

Financial statements do not comply with Ind AS if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows.

1.7.3.1 Potential errors of current period

Potential current period errors discovered in that period are corrected before the financial statements are approved for issue.

1.7.3.2 Prior period errors discovered subsequently

Material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period.

Following is the snapshot of how the balance sheet and statement of profit and loss is presented after correction of prior period errors:

Consolidated balance sheet

	Notes	31 March 2019	31 March 2018 Restated**	1 April 2017 Restated**
ASSETS				
Non-current assets				
Property, plant and equipment	3	137,048	97,023	88,145
Capital work-in-progress	3	17,450	3,100	-
Investment properties	4	7,419	7,179	7,255
Goodwill	5	8,670	4,530	4,530
Other intangible assets	5	12,033	10,895	11,210
Intangible assets under development*		-	-	-
Biological assets other than bearer plants*		-	-	-
Investments accounted for using the equity method	34(e)	2,776	2,128	1,604
Financial assets				
i. Investments	6(a)	38,165	32,253	32,299
ii. Loans	6(c)	3,084	2,601	2,182
iii. Other financial assets	6(e)	1,187	625	754
Deferred tax assets	7	4,598	2,774	2,054
Other non-current assets	8	21,586	10,565	7,466
Total non-current assets		**254,016**	**173,673**	**157,499**

Consolidated statement of profit and loss

	Notes	Year ended 31 March 2019	Year ended 31 March 2018 Restated**
Continuing operations			
Revenue from operations [31]	20	221,783	201,107
Other income	21(a)	4,430	3,444
Other gains/(losses) – net [1]	21(b)	1,233	1,203
Total income		**227,446**	**205,754**
Expenses			
Cost of materials consumed	22(a)	78,382	76,039
Purchases of stock-in-trade		62,763	45,632
Changes in inventories of work-in-progress, stock-in-trade and finished goods	22(b)	(7,038)	(2,428)
Excise duty [1]		-	3,174
Employee benefit expense	23	20,237	17,786
Depreciation and amortisation expense	24	10,820	9,761
Impairment of goodwill and other non-current assets [1]	3, 5	2,100	-
Net impairment losses on financial and contract assets [30]	29	443	454
Other expenses	25	9,591	8,801
Finance costs	26	3,203	2,794
Total expenses		**180,501**	**162,013**

Situation 1: Error discovered relates to the comparative prior period presented:

Unless impracticable, an entity shall correct material prior period errors **retrospectively** in the first set of financial statements approved for issue after their discovery by **restating the comparative amounts for the prior period(s)** presented in which the error occurred;

Example 14

While preparing the financial statement for the financial year 20X2-20X3, the prior period presented would be financial year 20X1-20X2, if one year comparative period is presented. If the error occurred in the year 20X1-20X2 but discovered in year 20X2-20X3, then it should be corrected in the financial statements for the year 20X2-20X3 by restating the comparative amounts for the year 20X1-20X2. This will result in consequential restatement of opening balances for the year 20X2-20X3.

Situation 2: Error discovered relates to period before the earliest comparative prior period presented:

If the material error occurred before the earliest prior period presented, an entity shall, unless impracticable, correct the same retrospectively in the first set of financial statements approved for issue after their discovery by **restating the opening balances of assets, liabilities and equity for the earliest prior period presented**.

Examples 15-17

15. An entity presents one year comparative period in its financial statements. While preparing the financial statements for the financial year 20X4-20X5, if an error has been discovered which occurred in the year 20X1-20X2, i.e., for the period which was earlier than earliest prior period presented (which is 20X3-20X4 in this example), then, the error should be corrected by restating the opening balances of relevant assets and/or liabilities and relevant component of equity for the year 20X3-20X4. This will result in consequential restatement of balances as at 1st April, 20X3 (i.e, the third balance sheet).

16. A material error in depreciation provision of the preceding year ended 31st March, 20X2 was discovered when preparing the financial statements for the year ended 31st March, 20X3. The amount recognised in statement of profit and loss for the year ended 31st March, 20X2 was ₹ 1,00,000 instead of ₹ 50,000. In this case, when presenting the financial statements for the year ended 31st March, 20X3, depreciation for the comparative year 20X1-20X2 will be restated at ₹ 50,000. The carrying amount i.e., net book value of property, plant and equipment for the comparative year ending 31st March, 20X2 will be increased by ₹ 50,000 (due to restatement of accumulated depreciation). This will result in consequential restatement of opening balance of retained earnings and property, plant and equipment for the year 20X2-20X3.

17. Continuing with the aforesaid example, assume that the error relates to year ended 31st March, 20X1 and 20X0-20X1 is not the earliest period for which comparative information is presented. In this case, the error will be corrected by restating the opening balances of retained earnings and carrying amount i.e., net book value, of property, plant and equipment, for the year 20X1-20X2. This will result in restatement of balances as at 1st April, 20X1.

Illustration 8

An entity has presented certain material liabilities as non-current in its financial statements for periods upto 31st March, 20X1. While preparing annual financial statements for the year ended 31st March, 20X2, management discovers that these liabilities should have been classified as current. The management intends to restate the comparative amounts for the prior period presented (i.e., as at 31st March, 20X1). Would this reclassification of liabilities from non-current *to current in the comparative amounts be considered to be correction of an error under Ind AS 8? Would the entity need to present a third balance sheet?*

Solution

As per paragraph 41 of Ind AS 8, errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements. Financial statements do not comply with Ind AS if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows. Potential current period errors discovered in that period are corrected before the financial statements are approved for issue. However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period.

In accordance with the above, the reclassification of liabilities from non-current to current would be considered as correction of an error under Ind AS 8. Accordingly, in the financial statements for the year ended 31st March, 20X2, the comparative amounts as at 31st March, 20X1 would be restated to reflect the correct classification.

Ind AS 1 requires an entity to present a third balance sheet as at the beginning of the preceding period in addition to the minimum comparative financial statements, if, inter alia, it makes a retrospective restatement of items in its financial statements and the restatement has a material effect on the information in the balance sheet at the beginning of the preceding period.

Accordingly, the entity should present a third balance sheet as at the beginning of the preceding period, i.e., as at 1st April, 20X0 in addition to the comparatives for the financial year 20X0-20X1.

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1.7.4 Limitations on retrospective restatement

We have already discussed in detail the treatment when there are the limitations on giving retrospective effect to changes in accounting policies. Similar provisions are included in Ind AS 8 to deal with limitations on retrospective restatement of prior period errors.

Step 1: A prior period error shall be corrected by retrospective restatement if it is practicable to determine both the period specific effects and cumulative effect of the error.

The correction of a prior period error is excluded from profit or loss for the period in which the error is discovered. Any information presented about prior periods, including any historical summaries of financial data, is restated as far back as is practicable.

Step 2: If it is not practicable to determine the period-specific effects of an error on comparative information for one or more prior periods presented, the entity shall first find out the earliest period for which retrospective restatement is practicable and then restate the opening balances of assets, liabilities and equity for that period. Ind AS 8 further states that such period can be the current period also.

For meaning of 'impracticable' for the purposes of Ind AS 8, see section 1.5.5.3.

Step 3: If it is not practicable to determine the cumulative effect, at the beginning of the current period, of an error on all prior periods, the entity shall restate the comparative information to correct the error prospectively from the earliest date practicable.

When it is impracticable to determine the amount of an error (e.g., a mistake in applying an accounting policy) for all prior periods, the entity restates the comparative information prospectively from the earliest date practicable. It therefore disregards the portion of the cumulative restatement of assets, liabilities and equity arising before that date.

Corrections of errors are distinguished from changes in accounting estimates. Accounting estimates by their nature are approximations that may need changing as additional information becomes known. For example, the gain or loss recognised on the outcome of a contingency is not the correction of an error.

1.8 DISCLOSURE OF PRIOR PERIOD ERRORS

An entity shall disclose the following:

(a) the nature of the prior period error;

(b) for each prior period presented, to the extent practicable, the amount of the correction:

  (i) for each financial statement line item affected; and

  (ii) if Ind AS 33 applies to the entity, for basic and diluted earnings per share;

(c) the amount of the correction at the beginning of the earliest prior period presented; and

(d) if retrospective restatement is impracticable for a particular prior period, the circumstances that led to the existence of that condition and a description of how and from when the error has been corrected.

Financial statements of subsequent periods need not repeat these disclosures.

1.9 IMPRACTICABILITY IN RESPECT OF RETROSPECTIVE APPLICATION AND RETROSPECTIVE RESTATEMENT

In some circumstances, it is impracticable to adjust comparative information for one or more prior periods to achieve comparability with the current period.

For example, data may not have been collected in the prior period(s) in a way that allows either retrospective application of a new accounting policy (including, its prospective application to prior periods) or retrospective restatement to correct a prior period error, and it may be impracticable to recreate the information.

It is frequently necessary to make estimates in applying an accounting policy to elements of financial statements recognised or disclosed in respect of transactions, other events or conditions. Estimation is inherently subjective, and estimates may be developed after the reporting period. Developing estimates is potentially more difficult when retrospectively applying an accounting policy or making a retrospective restatement to correct a prior period error, because of the longer period of time that might have passed since the affected transaction, other event or condition occurred. However, the objective of estimates related to prior periods remains the same as for estimates made in the current period, namely, for the estimate to reflect the circumstances that existed when the transaction, other event or condition occurred.

Therefore, retrospectively applying a new accounting policy or correcting a prior period error requires distinguishing information that

(a) provides evidence of circumstances that existed on the date(s) as at which the transaction, other event or condition occurred, and

(b) would have been available when the financial statements for that prior period were approved for issue

from other information.

For some types of estimates (eg a fair value measurement that uses significant unobservable inputs), it is impracticable to distinguish these types of information. When retrospective application or retrospective restatement would require making a significant estimate for which it is impossible to distinguish these two types of information, it is impracticable to apply the new accounting policy or correct the prior period error retrospectively.

Hindsight should not be used when applying a new accounting policy to, or correcting amounts for, a prior period, either in making assumptions about what management's intentions would have been in a prior period or estimating the amounts recognised, measured or disclosed in a prior period. For example, when an entity corrects a prior period error in calculating its liability for employees' accumulated sick leave in accordance with Ind AS 19, 'Employee Benefits', it disregards information about an unusually severe influenza season during the next period that became available after the financial statements for the prior period were approved for issue. The fact that significant estimates are frequently required when amending comparative information presented for prior periods does not prevent reliable adjustment or correction of the comparative information.

1.10 SIGNIFICANT DIFFERENCES BETWEEN IND AS 8 AND AS 5

S. No.	Particulars	Ind AS 8	AS 5
	Title	**Accounting Policies, Changes in Accounting Estimates and Errors**	**Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies**
1.	*Scope*	There are some differences in the scope of the two standards. For example, Ind AS 8 deals with the criteria for selecting and applying accounting policies.	Under AS, selection of accounting policies is dealt with in AS 1 'Disclosure of Accounting Policies'.
2.	*Extraordinary items*	Under Ind AS, presentation of any items of income or expense as extraordinary items is explicitly prohibited by Ind AS 1.	AS 5, on the other hand, requires separate presentation of extraordinary items in the statement of profit and loss. AS 5 defines extraordinary items as income or expenses

			that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly. As per AS 5, extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived.
3.	*Change in accounting policies*	Ind AS 8 does not deal with change in accounting policy on the basis of the requirement by the statute.	AS 5 allows change in accounting policy if required by the statute.
4.	*Accounting for changes in accounting policies*	Ind AS 8 requires that, subject to limited exceptions, changes in accounting policies should be accounted for retrospectively by restatement of comparative information. In addition, a third balance sheet as of the beginning of the preceding period is also required to be presented by an entity where it applies an accounting policy retrospectively and the retrospective application has a material effect on the	While AS 5 does not clearly specify how changes in accounting policies other than those dealt with by specific transitional provisions of an accounting standard should be accounted for (i.e., whether retrospectively or prospectively), it requires that the impact of, and the adjustments resulting from, a change in an accounting policy, if material, should be shown in the financial statements of the period in which the change is

		information in the balance sheet at the beginning of the preceding period.	made.
5.	*Prior period items*	Ind AS refers to the term 'prior period errors' which is wider in scope as compared to 'prior period items' used in AS 5. Ind AS 8 definition of prior period errors include the effects of misinterpretations of facts and fraud as well.	AS 5 defines prior period items as incomes or expenses which arise in the current period as a result of errors or omissions in the preparation of financial statements of one or more prior periods.
6.	*Correction of material prior period errors*	Ind AS 8 requires, subject to limited exception, retrospective correction of material prior period errors, i.e., restatement of comparative information and presentation of a third balance sheet as in case of a retrospective change in an accounting policy where the retrospective correction has a material effect on the information in the balance sheet at the beginning of the preceding period. Thus, under Ind AS 8, material prior period errors are corrected by correcting the recognition, measurement and disclosure of amounts of elements of financial statements retrospectively as if the prior period error had never occurred.	Unlike Ind AS 8, AS 5 requires the correction of prior period items by including the required adjustments in the determination of net profit or loss for the current period, though the standard also permits an alternative approach under which the adjustments are included in the statement of profit and loss after determination of current net profit or loss.

7.	*Disclosure requirements*	Disclosure requirements of Ind AS 8 are more detailed as compared to those of AS 5. For e.g. in case of a voluntary change in accounting policy, an entity is required to disclose the reasons why applying the new accounting policy provides reliable and more relevant information.	Disclosure requirements of AS 5 are less as compared to those of Ind AS 8.

FOR SHORTCUT TO IND AS WISDOM: SCAN ME!

TEST YOUR KNOWLEDGE

Questions

1. A carpet retail outlet sells and fits carpets to the general public. It recognizes revenue when the carpet is fitted, which on an average is six weeks after the purchase of the carpet.

   It then decides to sub-contract the fitting of carpets to self-employed fitters. It now recognizes revenue at the point-of-sale of the carpet.

   Whether this change in recognising the revenue is a change in accounting policy as per the provision of Ind AS 8?

2. Under what circumstances an entity is required to present a third balance sheet at the beginning of the preceding period?

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	₹ 14,000
	Net book value	₹ 11,000
(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 the relevant note for disclosure in accordance with Ind AS 8.

4. Is change in the depreciation method for an item of property, plant and equipment a change in accounting policy or a change in accounting estimate?

5. An entity charged off certain expenses as finance costs in its financial statements for the year ended 31st March, 20X1. While preparing annual financial statements for the year ended 31st March, 20X2, management discovered that these expenses should have been classified as other expenses instead of finance costs. The error occurred because the management inadvertently misinterpreted certain facts. The entity intends to restate the comparative amounts for the prior period presented in which the error occurred (i.e., year ended 31st March, 20X1). Would this reclassification of expenses from finance costs to other expenses in the comparative amounts will be considered as correction of an error under Ind AS 8? Would the entity need to present a third balance sheet?

Answers

1. This is not a change in accounting policy as the carpet retailer has changed the way that the carpets are fitted.

Therefore, there would not be any need to retrospectively change the prior period figures for revenue already recognized.

2. As per paragraph 40A of Ind AS 1, Presentation of Financial Statements, an entity shall present a third balance sheet as at the beginning of the preceding period in addition to the minimum comparative financial statements required by paragraph 38A of the standard if:

- it applies an accounting policy retrospectively, makes a retrospective restatement of items in its financial statements or reclassifies items in its financial statements; and
- the retrospective application, retrospective restatement or the reclassification has a material effect on the information in the balance sheet at the beginning of the preceding period.

3. **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; increase the opening deferred tax provision by ₹ 1,800; create a revaluation surplus at the start of the year of ₹ 4,200; increase depreciation expense by ₹ 500; and reduce tax expense by ₹ 150.

4. As per paragraphs 60 and 61 of Ind AS 16, Property, Plant and Equipment, the depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. The depreciation method applied to an asset shall be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method shall be changed to reflect the changed pattern. Such a change is accounted for as a change in an accounting estimate in accordance with Ind AS 8.

As per the above, depreciation method for a depreciable asset has to reflect the expected pattern of consumption of future economic benefits embodied in the asset. Determination of depreciation method involves an accounting estimate and thus depreciation method is not a matter of an accounting policy.

Accordingly, Ind AS 16 requires a change in depreciation method to be accounted for as a change in an accounting estimate, i.e., prospectively.

5. As per paragraph 41 of Ind AS 8, errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements. Financial statements do not comply with Ind AS if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows. Potential current period errors discovered in that period are corrected before the financial statements are approved for issue. However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period.

In accordance with the above, the reclassification of expenses from finance costs to other expenses would be considered as correction of an error under Ind AS 8. Accordingly, in the financial statements for the year ended 31st March, 20X2, the comparative amounts for the year ended 31st March, 20X1 would be restated to reflect the correct classification.

Ind AS 1 requires an entity to present a third balance sheet as at the beginning of the preceding period in addition to the minimum comparative financial statements if, inter alia, it makes a retrospective restatement of items in its financial statements and the restatement has a material effect on the information in the balance sheet at the beginning of the preceding period.

In the given case, the retrospective restatement of relevant items in statement of profit and loss has no effect on the information in the balance sheet at the beginning of the preceding period (1st April, 20X0). Therefore, the entity is not required to present a third balance sheet.