COLLEGE OF ACCOUNTING

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Video Transcription: Identifying a Change in Accounting Policy

Hi, my name is Alex. When a company changes the way in which it recognises an asset or a liability, are you able to tell whether that change is as a result of a change in accounting policy, change in circumstance or a change in estimate? It does matter because it influences the way in which the change is recognised and the disclosure that is required. In this video, what we are going to do is focus on identifying what is and what is not a change in accounting policy and in a separate video, we are going to have a look at how to deal with any change in accounting policy. Now, the key aspect to understanding whether something is a change in accounting policy, is understanding the definition of what an accounting policy is.

An accounting policy is defined as the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements. An accounting policy is a generic description of how a transaction is recognised. It doesn't include specific details relating to an individual transaction or any amounts.

What it does do, is it tells you three things about how an item is measured. It tells you how it is recognised, it tells you how it is presented and it tells you how it is measured. With recognition telling you whether it is an asset or an expense, presentation will tell you which part of the financial statements it's going to be recognised in, possibly whether it's going to be disclosed on a gross basis or whether two similar items are going to be netted off against each other, and measurement is going to tell you whether it is measured on a cost basis, perhaps depreciated cost, perhaps fair value. And to have it change an accounting policy, one of those three aspects need to change: recognition, presentation or measurement. Conversely, if none of those change: no change in recognition, presentation or measurement, there is not a change in accounting policy.

In this video, what we are going to focus on, is inventory and "property, plant and equipment" and I meant to use those as examples to illustrate those principles and test that definition. In a document attached to this video, we are going to deal with a broader variety of ttransactions types, perhaps some of them are out of the scope of your syllabus at this stage but you may be interested to go and have a look at those.

Let's start by thinking about inventory. As you know a company has to, at each reporting date, determine how much of the purchases it made during the year, are still available at the end of the year. And those are going to be recognised on the Statement of Financial Position as an asset, it is called "inventory", with a balance being recognised as an expense in the form of cost of sales. Now how do we determine, which items are on hand at the end of the year, how do we measure the cost of those items? Now, if we can identify exactly what items we have got, then it is easy. In that case, we would simply take the cost of those specific items and that will give us our closing inventory. But what happens if we've got a lot of interchangeable items and we cannot tell exactly which ones we have got left at the end of the year?

In that case, there are two different ways in which we can do it, two different bases for allocating the cost. One is weighted average, one is first-in-first-out, typically known as FIFO. Now, in our accounting policies we would specify which basis we have measured cost and that would be part of our accounting policies, and if we were to change that basis that would give rise to a change in policy, and the reason for that is that one of those three aspects, the measurement, has changed and therefore we have a change in accounting policy. Let's think about depreciation. The typical policy for the depreciation could be: depreciation is the systematic allocation of the depreciable amount of an asset over its useful life and is recognised as an expense unless it relates directly to the construction of another asset such as inventory. The estimated useful life, residual value and depreciation methods are reviewed at the end of each reporting period.

Note that this policy explains how the amounts are recognised, and how they are presented. It does not explain how they are calculated, that is based on your current estimate of what the useful life is and what an appropriate systematic allocation is, of the consumption of that asset. And It's important to note that the measurement basis is the same, we are continuing to depreciate that asset by allocating the best estimate of a useful life. Changing from one way to the other is simply changing what the best estimate is of the systematic allocation at this point in time.

In other words, changing from reducing balance to the straight-line method of depreciation is not a change is accounting policy, it is a change in estimate.

It's also important to distinguish between a change in accounting policy and a change in circumstances. Assume that your company has accounting policies that include the following:

Investment property is measured at fair value, owner occupied property is measured at depreciated cost and assume that you've got a warehouse and it has been surplus to your requirements and you've been renting it out, it would therefore have been classified as an investment property. Business is going well and you have expanded and now you need to use that warehouse yourself, it then becomes an owner occupied property. So for that particular property, the measurement basis has changed from fair value to depreciated cost. Look at those policies again, investment property continued to be measured using the fair value model. Owner occupied property continued to be measured using the depreciated cost model, this is not a change in accounting policy, this is a change in circumstance and the correct accounting treatment here would be to recognise it at fair value until such point as it becomes owner occupied and from then on you will be recognising it at the depreciated cost model. That is not a change in accounting policy, it is a change in particular circumstance.

If you decide to revalue your property, plant and equipment, that is a change in the measurement basis of that asset and that would give rise to a change in accounting policy. Remember also, the presentation changes, could be a change in accounting policy. Think about the choice as to how you present your operating costs, function basis or a nature basis, the change from one to another will be a change in accounting policy.

Despite the fact that it doesn't change your profit, it is a different way of presenting your operating costs. Let's also think about this in a group situation. Remember that you need to apply your policies consistently from a group perspective. Think about investment property and imagine that the parent company uses the fair value model and subsidiary company uses the depreciated cost model for investment property. When we bring that subsidiary company into the group accounts, the group policy of fair value needs to be applied. The subsidiary companies' results are therefore going to have to be changed from depreciated cost to the fair value model. That is not a change in accounting policy, what we are dong there, is trying to make sure that our policies are applied consistently and we would have done exactly the same basis last year. Obviously a more efficient way to do that would be for the subsidiary company to change its policy.

The other thing to remember is that those policies need to be applied correctly from a group perspective. Imagine the parent company owns a property that it rents out to the subsidiary company. The parent company has an investment property. The group as an entity has an owner occupied property and therefore in the group accounts, depreciated cost is the model, whereas in the parent company fair value would be the model for its investment property. That again is not a change in accounting policy, it is a change in circumstance, taking into account the reporting entity that we are having to look at. Just to recap: remember that you have a change in accounting policy, you need to have a change in one of those three aspects, without a change in one of those, there is no change in accounting policy.

And just to remind you that, where it's not clear, if you have got a change in policy or not, you then need to treat it as a change in accounting estimate. I hope now that you've got the skills that you need to identify a change in accounting policy. I hope this has been helpful and I hope you will join me soon in watching the video where we will discuss how to deal with a change in accounting policy.

Thank you and goodbye.