Mr Jean-Paul Gauzès
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Dear Jean-Paul

Thank you for providing the Financial Reporting Council (FRC) with the opportunity to comment on your draft comment letter (DCL) to the IASB on the Exposure Draft (ED) ED/2017/5 '*Accounting Policies and Accounting Estimates (Proposed amendments to IAS 8)*'. Our detailed comments on EFRAG's DCL are set out in the appendix to this letter and we have included our response to the IASB for your information.

Like EFRAG, we support the IASB's objective of clarifying the criteria for distinguishing between a change in an accounting policy and a change in an accounting estimate, to encourage more consistent application of the requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*' (IAS 8). However, while it may not be possible to eliminate any potential overlap between the definitions, we believe they could be better articulated so that the distinction is clearer.

We do not support the inclusion of the rule in relation to the treatment of cost formulas applied to ordinarily interchangeable inventories, proposed in paragraph 32B of the ED. In our view, the revised principles and definitions in IAS 8 should be sufficiently clear to enable companies to make the determination without recourse to a specific rule for this circumstance. Moreover, the rule in paragraph 32B does not appear to be derived from or consistent with the definitions of 'accounting policies' and 'accounting estimates' in paragraph 5, and appears to conflict with paragraph 35 of IAS 8 given the contentious nature of the matter.

In our view, the measurement base in this case is the accounting policy (i.e. that inventory is accounted for at the lower of cost and net realisable value) and the cost formula is an accounting estimate selected to be used in applying that accounting policy.

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

Yours sincerely

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Appendix – FRC comments on EFRAG's DCL

> **Question 1**
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> The Board proposes clarifying the definition of accounting policies by removing the terms 'conventions' and 'rules' and replacing the term 'bases' with the term 'measurement bases' (see paragraph 5 and paragraphs BC5–BC8 of the Basis for Conclusions).
>
> Do you agree with this proposed amendment? Why or why not? If not, what do you propose and why?

We largely agree with EFRAG's comments in paragraphs 4-6 of the DCL, particularly that the proposals may not deliver sufficient clarification of the principles for distinguishing an accounting policy from an accounting estimate. We agree with the term 'practices' being retained so that the definition of 'accounting policies' captures those accounting policies developed in the absence of specific guidance in IFRS as described in paragraphs 10-12 of IAS 8, and any practical expedients applied (which constitute a departure from the principles in IFRS). However, we have suggested to the IASB that, if this is the intended meaning of the term in this context, this should be stated explicitly in the Standard.

> **Question 2**
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> The Board proposes:
>
> (a) clarifying how accounting policies and accounting estimates relate to each other, by explaining that accounting estimates are used in applying accounting policies; and
>
> (b) adding a definition of accounting estimates and removing the definition of a change in accounting estimate (see paragraph 5 and paragraphs BC9–BC16 of the Basis for Conclusions).
>
> Do you agree with these proposed amendments? Why or why not? If not, what do you propose and why?

Like EFRAG, we agree with the IASB's decision to remove the definition of 'a change in accounting estimate' and instead define 'accounting estimates' because this should make it easier to distinguish accounting estimates from accounting policies. We also support the definition of 'accounting estimates' in paragraph 5 of the ED. We believe that defining 'accounting estimates' at this level of granularity will enable clearer distinction between changes in accounting estimates and other changes such as the availability of new or more accurate data.

That said, we also agree with EFRAG that the distinction between the accounting policies and accounting estimates could be more clearly articulated, to reduce the perceived overlap in the

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definitions. The retention of the term ‘practices’ in the definition of ‘accounting policies’ (without clarification of its meaning in this context) leaves potential for overlap with the definition of ‘accounting estimates’ because certain estimation techniques or valuation techniques—which are accounting estimates—could be described as practices. We agree with EFRAG that further illustrative examples could help to reduce confusion but, in our view, it is important that the definition of ‘accounting policies’ is clarified in the Standard itself.

Question 3

The Board proposes clarifying that when an item in the financial statements cannot be measured with precision, selecting an estimation technique or valuation technique constitutes making an accounting estimate to use in applying an accounting policy for that item (see paragraph 32A and paragraph BC18 of the Basis for Conclusions).

Do you agree with this proposed amendment? Why or why not? If not, what do you propose and why?

Like EFRAG, we support the IASB’s objective of providing further guidance regarding changes in an estimation technique or valuation technique. We note that paragraph 32A is consistent with the requirement in paragraph 66 of IFRS 13 *Fair Value Measurement* concerning the treatment of a change in valuation techniques.

Question 4

The Board proposes clarifying that, in applying IAS 2 Inventories, selecting the first-in, first-out (FIFO) cost formula or the weighted average cost formula for interchangeable inventories constitutes selecting an accounting policy (see paragraph 32B and paragraphs BC19–BC20 of the Basis for Conclusions).

Do you agree with this proposed amendment? Why or why not? If not, what do you propose and why?

We agree with EFRAG that the diversity in practice in the application of IAS 2 *Inventories* (IAS 2) should be addressed, but we do not support the IASB’s proposal in paragraph 32B. We do not agree with the inclusion in IAS 8 of a rule for this specific circumstance. Instead, we recommend that the principles in IAS 8 are redrafted so that they are sufficiently clear to enable companies to apply them to different scenarios without recourse to a rules-based approach.

We do not agree that for ordinarily interchangeable inventories, the sequence in which items are sold never has economic significance or that a cost formula is never selected on the basis that it most closely approximates the consumption pattern of inventory. Paragraphs BC10-BC11 of IAS 2 explicitly acknowledge that cost formulas are an approximation of the

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consumption pattern of inventory, hence the fact that use of the LIFO formula is prohibited because it "is generally not a reliable representation of actual inventory flows" and imposes "an unrealistic cost flow assumption". In our view, the measurement base applied to inventories is the accounting policy (i.e. that inventory is accounted for at the lower of cost and net realisable value) and the cost formula is an accounting estimate selected to be used in applying that accounting policy.

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

Our letter to the IASB also notes that if the selection of a cost formula is the selection of an accounting policy and is not based on an approximation of the consumption pattern of inventory (as asserted in paragraph 32B of the ED), it is not clear in what circumstances the threshold for accounting policy changes set out in paragraph 14(b) of IAS 8 could be met and a change in cost formula permitted, if it is not required by paragraph 14(a).

Paragraph 22 of EFRAG's DCL suggests that if the IASB proceeds with the requirement proposed in paragraph 32B of the ED it should be included in IAS 2 as well as IAS 8. Our preference is for paragraph 32B to be removed entirely. However, if the IASB does retain it, in our view it should be included only in IAS 2 because its inclusion in IAS 8 could lead to inappropriate analogies being drawn in other circumstances.

Question 5

Do you have any other comments on the proposals?

We agree with the comments in paragraphs 23 to 25 of EFRAG's DCL.

Our letter to the IASB suggests that, while amending IAS 8, it takes the opportunity to clarify the requirements for reporting of the effect of changes in estimates. We suggest that paragraph 39 is amended to require the disclosure of the financial statement line items that are affected.

We have also suggested to the IASB that paragraph 54F could be drafted more concisely, stating simply that the requirements are to be applied prospectively from the effective date, with early application permitted.

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