European Securities and Markets Authority

The Chair

Date: 1 July 2013
ESMA/2013/854

Mr Wayne Upton
IFRS IC
Cannon Street 30
London EC4M 6XH
United Kingdom

Ref: Agenda item request: Application of IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors to distinguish between a change in accounting estimate and a change in accounting policy

Dear Mr Upton,

The European Securities and Markets Authority (ESMA) is an independent EU Authority that contributes to enhancing the protection of investors and promoting stable and well-functioning financial markets in the European Union (EU). ESMA achieves this aim by building a single rule book for EU financial markets and ensuring its consistent application across the EU. ESMA contributes to the regulation of financial services firms with a pan-European reach, either through direct supervision or through the active co-ordination of national supervisory activity.

As a result of the enforcement activities carried out by national competent authorities ESMA has identified an issue related to the application of IAS 8 – *Accounting Policies, Changes in Accounting Estimates and Errors*, which we would like to bring to the attention of the IFRS Interpretations Committee for adding it to its agenda.

A detailed description of the issue is set out in the appendix to this letter. We would be happy to further discuss this issue with you.

Yours sincerely,

Steven Maijoor

Chair

European Securities and Markets Authority

APPENDIX – DETAILED DESCRIPTION OF THE ISSUE

1. Enforcers have identified divergent practices regarding the assessment of whether a change qualifies as a change in an accounting policy or as a change in an accounting estimate in accordance with IAS 8, as illustrated in the examples below.

Description of the issue

2. The distinction between a change in accounting estimate and a change in accounting policy is particularly important because IFRS requires a different accounting treatment resulting in application of the change prospectively or retrospectively.

3. Moreover, IAS 8 sets out stricter criteria for changes in accounting policy than for changes in accounting estimate. According to paragraph 14(b) of IAS 8, in order to change an accounting policy the issuer should be able to justify that the change provides more relevant information, whereas there is no such requirement for a change in accounting estimate.

4. Recent debates at the IFRS IC on the request for guidance on the determination of the rate used to discount post-employment benefit obligations show that IFRS IC members were divided on the qualification of a change of the way to determine a discount rate. The November 2012 IFRS IC Update[1] states that "*the Interpretations Committee briefly discussed, but did not conclude, on whether a change to the way in which an entity determines the discount rate would be a change in accounting policy or a change in estimate*".

5. ESMA is concerned that diversity in practice may exist regarding this qualification. ESMA provides the following examples to illustrate the ambiguities arising from the assessment whether a change qualifies as a change in accounting policy or as a change in accounting estimate.

Example A - Change in the own credit risk calculation

6. Historically, bank A computed its own credit risk for the measurement of its financial liabilities at fair value using credit default swap (CDS) curves. Following the financial crisis and the dislocation of the CDS market, bank A modified its methodology and assessed its own credit risk at year-end based on the spread of its most recent debt issuance.

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[1] IFRS IC Update – November 2012, IFRS Foundation, November 2012

View 1

7. Supporters of view 1 believe that this change is a change in accounting policy, as the basis for determining the own credit risk changed from CDS curve method to a methodology based on the spread of the historical debt issuances.

View 2

8. Supporters of view 2 argue that this is a change in accounting estimate because the objective of the accounting policy related to the measurement of own credit risk has not changed. The method of valuation was modified as the CDS curve was no longer relevant. Hence, according to this view, this change is due to "*changes which occurred in the circumstances on which the estimate was based*" as referred to in paragraph 34 of IAS 8.

Example B – Change in the definition of High Quality Corporate Bonds

9. The subject was briefly discussed during the November IFRS IC meeting as part of the discussion on high quality corporate bonds (HQCB) in IAS 19 and IFRS IC members expressed diverging views on whether such change would qualify as a change in accounting policy or a change in accounting estimate.

View 1

10. Proponents of view 1 believe that a change in the reference used to determinate the discount rate is a change in accounting policy because the measurement basis used in determining the discount rate changed. If an issuer used in the past the yield of AA-rated bonds, switching to the yield of BBB-rated bonds is a change in the measurement basis.

11. They argue that the change is not a change in accounting estimate because the issuer had chosen AA-rated bonds as a definition for HQCB. Changing the definition of a concept cannot be a change in estimate.

View 2

12. Proponents of view 2 argue that this change is not a change in accounting policy because the objective which is to determine the discount rate with the reference to the yield of HQCB did not change (i.e. there was no change in measurement basis). The fact that the yield of HQCB was formerly evaluated using AA-rated bonds and is now evaluated using BBB rated bonds is a change in accounting estimate. The number of AA-rated entities is no longer sufficient and consequently it is more relevant to use BBB-rated bonds. Hence, this change is due to "*changes which occurred in the circumstances on which the estimate was based*" as referred to in paragraph 34 of IAS 8.

Other examples

13. ESMA notes other examples where the assessment whether a change qualifies as a change in accounting policy or as a change in accounting estimate is difficult:

    a. a change in the "*significant or prolonged*" criteria which trigger impairment for Available for Sale equity instruments in accordance with paragraph 61 of IAS 39 - *Financial Instruments: Recognition and Measurement*,

    b. a change of method of credit value adjustment (CVA) calculation, from historical approach to determine the probability of default and the loss given default to market based approach,

    c. a change in the measurement formula of the cost of the inventories from first-in-first-out (FIFO) to weighted average cost.

Request

14. ESMA would suggest that the criteria to distinguish a change in accounting policy from a change in accounting estimate need to be clarified. In particular, ESMA suggests the IASB to clarify whether the reason to justify the change should be taken into account (e.g. voluntary change or change due to external circumstances) and if so on what basis.

15. Furthermore, ESMA finds that there might be a need to clarify the interaction between the following paragraphs in different IFRSs:

    - paragraph 66 of IFRS 13 - *Fair Value Measurement* which states that a change in a valuation methodology is a change in accounting estimate,

    - paragraph 35 of IAS 8 which notes that a change in the measurement basis applied is a change in accounting policy, and

    - paragraph 118 of IAS 1 - *Presentation of Financial Statements* which states that measurement bases (e.g. historical cost, current cost, net realisable value, fair value and recoverable amount) are accounting policies.