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THE IMPACT OF CHANGES IN ACCOUNTING POLICIES AND ACCOUNTING ESTIMATES ON FINANCIAL REPORTING

Vilena TIȘCENCO[18] PhD Student
Galina BĂDICU [19] PhD Professor

ORCID number (https://orcid.org/):

Abstract: *The evolving landscape of financial reporting necessitates continuous updates and modifications in accounting policies and estimates to ensure the relevance and reliability of financial statements. This article explores the impact of changes in accounting policies and accounting estimates on financial reporting. This study highlights the significance of consistency and transparency in the application of accounting policies and the formulation of estimates by analyzing the International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Principles (GAAP). Modifications in accounting policies, whether due to regulatory updates or management's strategic decisions, can have a substantial impact on how an entity's financial position, performance, and cash flows are presented and understood. Likewise, accounting estimates, which require judgments and assumptions regarding uncertain future events, can influence major financial statement components, including asset valuations, impairment charges, and provisions.*

The article explores the reasons for these changes, the steps required for their implementation, and their impact on various stakeholders such as investors, regulators, and auditors. It underscores the importance of strict disclosure standards to reduce the risk of financial misrepresentation and improve comparability across different reporting periods. The relationship between accounting policies and estimates is examined in depth to assess their combined effect on the quality of financial information. Additionally, the study points out the difficulties entities encounter in adhering to evolving accounting standards while ensuring consistency in their financial reporting.

The evolving landscape of accounting standards requires constant review and adaptation of accounting policies and estimates to uphold the quality and trustworthiness of financial reporting. This paper offers insights into both the theoretical and practical effects of such changes, enhancing comprehension of their significance in financial reporting and their influence on stakeholders' decision-making. It emphasizes the need for continuous research and active discussions among professionals, standard-setters, and scholars to address the challenges linked to modifications in accounting policies and estimates, with the goal of achieving improved precision, relevance, and dependability in financial reporting.

Key words: *accounting policies, accounting estimates, financial performance, financial reporting, Generally Accepted Accounting Principles, International Financial Reporting Standards.*

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1. Introduction

The ongoing evolution of accounting standards and practices necessitates periodic changes in accounting policies and estimates to ensure the accuracy and reliability of financial reporting. This paper investigates the impact of such changes on financial statements, providing a comprehensive analysis of their implications for stakeholders. Accounting policies refer to the particular principles, methods, conventions, rules, and practices that an entity uses in the preparation and presentation of

[18] vilenatiscenco1996@gmail.com, Academy of Economic Studies of Moldova/Stefan cel Mare University of Suceava, Romania
[19] badicu.galina@ase.md, Academy of Economic Studies of Moldova

its financial statements. These policies are essential for accurately representing the financial position and performance of the entity. In contrast, accounting estimates involve the judgments made by management to determine values for assets, liabilities, income, expenses, and related disclosures, which inherently come with uncertainties.

Adjustments to accounting policies and estimates are typically prompted by the necessity to keep financial reporting aligned with changing business conditions, regulatory mandates, and industry best practices. Standards like the International Financial Reporting Standards (IFRS), along with other regulatory authorities, periodically revise their guidance to improve the transparency, comparability, and reliability of financial reports. Such revisions can significantly affect an entity's financial statements, influencing reported income, asset valuations, liabilities, and equity. Additionally, these changes may alter key financial ratios and metrics, which are essential for stakeholders making well-informed decisions.

This study investigates the processes involved in implementing changes to accounting policies and estimates, differentiating between voluntary and mandatory changes. Voluntary changes are usually driven by management's desire to enhance the relevance or reliability of the financial representation of the company, whereas mandatory changes result from regulatory updates or modifications to accounting standards. The paper discusses the criteria for choosing and applying new accounting policies and explores the methods used for updating accounting estimates. Additionally, it addresses the retrospective and prospective applications of these changes, clarifying when each approach is appropriate and highlighting the potential challenges that may arise with their implementation.

The effects of changes in accounting policies and estimates go beyond mere numerical revisions; they can influence how an entity's financial stability and future outlook are perceived. This paper highlights the critical role of transparency and detailed disclosure in maintaining stakeholders' trust and confidence amid such changes. It advocates for strong governance structures and prudent management decision-making to ensure that these adjustments clarify rather than obscure the entity's actual financial condition.

2. Conceptual Framework

Accounting policies and accounting estimates are essential elements in financial reporting, each fulfilling a unique role in the preparation and presentation of financial statements.

Accounting Policies: These refer to the specific principles, methods, conventions, rules, and procedures that an organization uses in the preparation and presentation of its financial statements. These policies guide how financial transactions and events are recorded, measured, displayed, and disclosed within the financial reports. They play a crucial role in maintaining consistency and facilitating the comparability of financial data over time and among various entities. Examples of such policies include approaches for inventory valuation (e.g., FIFO or LIFO), depreciation techniques (e.g., straight-line or declining balance), and revenue recognition criteria.

Accounting Estimates: These are approximations or judgments made by management regarding the value of certain items or transactions, where precise measurement is not possible due to uncertainty. Accounting estimates are necessary when the outcome of future events cannot be predicted with certainty. Common examples of accounting estimates include the allowance for doubtful accounts, estimated useful lives of fixed assets, provisions for warranties, and estimates of impairment losses.

Unlike accounting policies, which provide a general framework, accounting estimates involve specific judgments about amounts and timing.

Changes in accounting policies and estimates can significantly impact financial reporting. These modifications may alter how financial information is recognized, measured, presented, and disclosed, affecting the comparability, transparency, and relevance of financial statements. It is crucial for stakeholders, such as investors, creditors, regulators, and management, to understand the effects of these changes, as they rely on financial statements to inform their decision-making.

3. The Role of Accounting Policies and Estimates in Financial Reporting

Accounting policies and estimates are essential for ensuring that financial statements accurately reflect an entity's financial condition, performance, and cash flows. They serve to connect the theoretical foundations of accounting with the actual circumstances of business activities.

✓ **Ensuring Consistency:** A key function of accounting policies is to maintain uniformity in financial reporting. By following a specific set of guidelines, organizations can present financial data that is comparable across various reporting periods and different entities. The consistent application of accounting policies aids users of financial statements in recognizing trends and making valid comparisons over time.

✓ **Reflecting Economic Reality:** Accounting estimates play a crucial role in portraying the actual economic conditions of a business's operations. Given that certain elements of financial reporting are inherently uncertain, estimates enable management to offer their most informed judgment regarding future outcomes. This approach ensures that financial statements accurately reflect reality and are not misleadingly precise.

✓ **Facilitating Decision-Making:** Accounting policies and estimates play a vital role in enabling stakeholders to make well-informed decisions. Investors, creditors, and other users of financial reports depend on accurate and trustworthy information for their economic choices. When accounting policies are thoughtfully selected and consistently implemented, along with sound accounting estimates, they provide a solid basis for evaluating an organization's financial condition and potential for future growth.

✓ **Supporting Compliance and Governance:** The use of accounting policies and estimates also aids in meeting regulatory obligations and governance standards. Organizations must adhere to specific accounting frameworks, such as IFRS or GAAP, which require the uniform application of policies and judicious use of estimates. Adhering to these standards ensures that financial reporting meets regulatory expectations and follows best practices, thereby bolstering the credibility and dependability of financial statements.

To provide a clear understanding of accounting policies and estimates, Table 1 presents a comparison of their key features.

Table 1. Comparison of Accounting Policies and Accounting Estimates

Feature	**Accounting Policies**	**Accounting Estimates**
Definition	Principles and rules for financial reporting	Approximations based on judgment and assumptions
Nature	General guidelines	Specific to particular transactions or events
Stability	Relatively stable over time	Variable, based on new information or changing circumstances
Impact on Financial Statements	Affects recognition, measurement, and disclosure of transactions	Affects valuation and estimation of items
Change Application	Retrospective, with adjustments to past periods	Prospective, affecting current and future periods only
Disclosure Requirements	Detailed description and justification for any changes	Disclosure of assumptions, methods, and impact of changes

Source: developed by the author based on Schipper (2007)

Table 1 highlights the fundamental differences between accounting policies and accounting estimates, providing a succinct overview for understanding how they each contribute to financial reporting. While both accounting policies and estimates are integral to financial reporting, they differ in several key aspects:

1. **Nature and Scope:**

- **Accounting Policies** consist of overarching principles that dictate the methods and procedures utilized in the preparation of financial statements. These policies tend to remain consistent over time and establish a framework for recording and reporting financial transactions.
- **Accounting Estimates**, on the other hand, are particular assessments made for specific items within the financial statements. They require the application of assumptions and professional judgment to determine values that are inherently uncertain.

2. **Application and Changes:**

- **Accounting Policies** tend to remain stable over time; however, they may be modified in response to new regulations, shifts in business operations, or management's choice to deliver more pertinent information. When accounting policies are changed, disclosure is necessary, and these changes are usually applied retrospectively to maintain comparability between different reporting periods.
- **Accounting Estimates**, by their nature, are subject to variability and can be revised as new information emerges or as the conditions influencing those estimates change. Adjustments to estimates are made on a prospective basis, affecting only the current and future periods without necessitating modifications to prior financial statements.

3. **Impact on Financial Statements:**

- **Changes in Accounting Policies** can greatly influence the recognition and reporting of financial transactions, potentially modifying critical financial indicators such as revenue, profit, and asset values. For instance, switching from one method of inventory valuation to another can lead to changes in the cost of goods sold and the valuation of inventory.

- **Changes in Accounting Estimates** impact the assessment of particular items in the financial statements, including allowances, provisions, and asset impairments. Such changes can directly affect the financial outcomes of the current period and may also have repercussions for future periods, depending on how these estimates are adjusted over time.

4. **Disclosure Requirements:**

- **Accounting Policies** require disclosure of the principles and methods employed in the preparation of financial statements, including any changes made and their implications. This is crucial for ensuring transparency and assisting users in comprehending the foundation of financial reporting.
- **Accounting Estimates** mandate the disclosure of the nature and magnitude of significant estimates, along with justifications for any changes and the assumptions underlying them. This information aids users in grasping the judgments that have been made and the extent to which financial statements are affected by these judgments.

5. **Role in Risk Management:**

- **Accounting Policies** provide a structured approach to financial reporting, ensuring consistency and minimizing the likelihood of subjective or biased outcomes. By following standardized policies, organizations reduce the risk of financial misrepresentation and improve the dependability of their financial statements.
- **Accounting Estimates** carry inherent risks because they are based on the uncertain nature of future events. The dependability of these estimates is influenced by the accuracy of the assumptions and judgments made by management. Effective risk management requires ongoing monitoring and adjustment of estimates to incorporate new data and evolving conditions.

Grasping the differences and interactions between accounting policies and accounting estimates is crucial for producing accurate and trustworthy financial reports. Accounting policies establish a consistent foundation for financial reporting, promoting comparability across periods and entities. On the other hand, accounting estimates address uncertainties and necessitate judgment to accurately depict the economic realities of business activities. When combined, these elements allow organizations to provide a genuine and fair representation of their financial status and performance, facilitating informed decision-making for diverse stakeholders. As accounting standards continue to develop, it is imperative for regulators, standard-setters, and practitioners to prioritize the maintenance of a clear and robust conceptual framework for these components.

4. Regulatory Framework

The regulatory framework that governs accounting policies and estimates plays a critical role in ensuring consistency, transparency, and reliability in financial reporting across various jurisdictions. This section explores the primary regulatory frameworks, with a focus on International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Principles (GAAP), and how they offer guidance on adjustments to accounting policies and estimates. Additionally, it highlights the significance of disclosure requirements in preserving the integrity of financial reporting.

Changes in accounting policies involve modifications to the accounting principles, conventions, rules, or practices used by an entity in the preparation of its financial statements. Regulatory frameworks, such as IFRS and GAAP, establish specific guidelines on when and how these changes should be implemented and communicated.

Under IFRS (IAS 8):

- **Permissible Changes:** Accounting policy changes are permitted only when mandated by a new or updated standard or interpretation, or when the change enhances the reliability and relevance of the financial statements in reflecting the impact of transactions, events, or conditions.
- **Retrospective Application:** When an accounting policy change occurs, it is typically applied retrospectively. This requires the entity to revise the opening balances of relevant assets, liabilities, and equity for the earliest period presented, treating the new policy as if it had been in place from the outset. This method guarantees consistency and comparability of financial statements across periods.
- **Disclosure Requirements:** Entities are required to disclose the nature and rationale for any change in accounting policy, along with the adjustment amounts for each financial statement line item impacted, for both the current and prior periods. Additionally, they must indicate that the change has been applied retrospectively. If retrospective application is not feasible, this must be disclosed along with the reason for the impracticality.

Under GAAP:

- **Permissible Changes:** Similar to IFRS, under GAAP, changes in accounting policies are allowed if required by a new accounting standard or if they result in more reliable and relevant financial information.
- **Retrospective Application:** GAAP typically mandates the retrospective application of changes in accounting policies. This involves adjusting the financial statements for all periods presented, with the cumulative impact of the change on earlier periods reflected in the opening balance of retained earnings for the first period presented.
- **Disclosure Requirements:** GAAP requires entities to disclose the nature of the accounting policy change, the reasoning behind it, the method of implementation, and its effects on the financial statements, including its impact on net income and any adjustments made to previous periods.

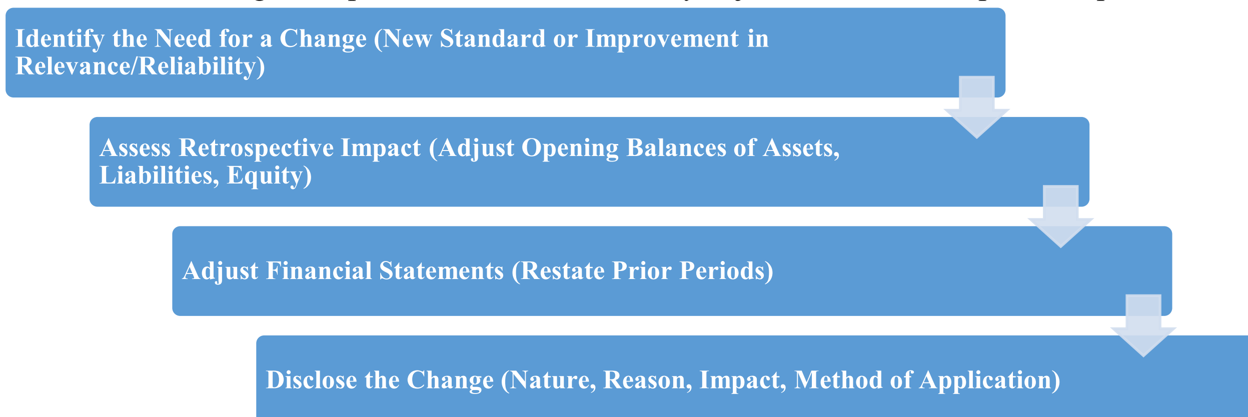

Figure 1. Process for Changing Accounting Policies Under IFRS and GAAP

Source: developed by the author based on Kieso et al. (2020)

Changes in accounting estimates arise from the emergence of new information or developments and involve adjustments to the carrying values of assets and liabilities, as well as associated expenses. In contrast to changes in accounting policies, changes in estimates are applied on a prospective basis.

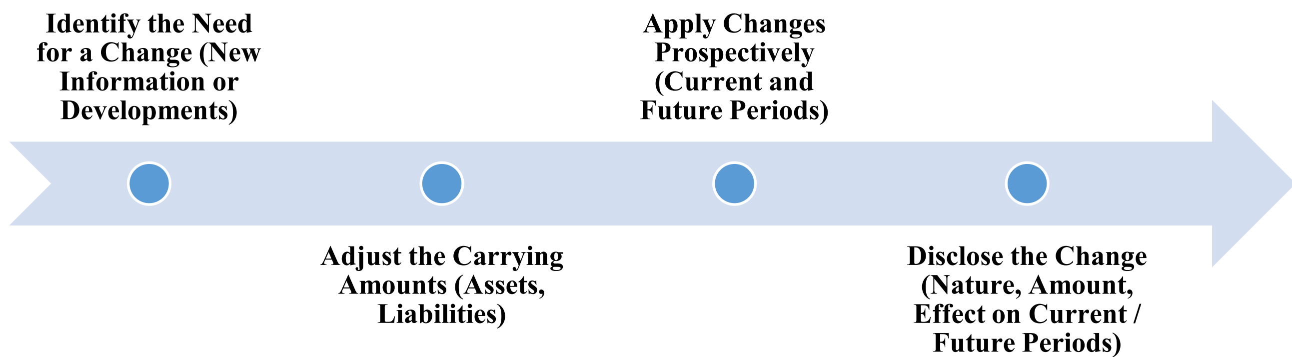

Figure 2: Process for Changing Accounting Estimates Under IFRS and GAAP
Source: developed by the author based on Kieso et al. (2020)

Under IFRS (IAS 8):

- **Prospective Application:** When changes in accounting estimates occur, they are implemented on a prospective basis, meaning they only influence the current and future reporting periods. For example, if the estimated useful life of an asset is modified, the remaining depreciation expense will be allocated over the newly determined useful life starting from the current period.
- **Disclosure Requirements:** Entities are required to disclose both the nature and the amount of any changes in accounting estimates that significantly impact the current period or are anticipated to have a substantial effect in future periods. If it is not feasible to estimate the impact, this limitation must also be communicated.

Under GAAP:

- **Prospective Application:** GAAP mandates that changes in accounting estimates be applied prospectively. This means that any adjustments should be reflected in the period in which the change occurs and in subsequent periods if the change impacts both. For instance, adjustments to estimates related to doubtful accounts, warranty obligations, or asset impairments are recorded on a prospective basis.
- **Disclosure Requirements:** GAAP stipulates that the nature and impact of any changes in estimates must be disclosed. If it is impractical to estimate the effect on future periods, this limitation should be explicitly stated.

5. Impact of Changes in Accounting Policies and Estimates on Financial Statements

The analysis of modifications in accounting policies and estimates highlights their significant effects on the quality, dependability, and comparability of financial reporting. Such changes can greatly affect financial statements, influencing essential metrics like profitability, liquidity, and solvency, all of which are vital for stakeholders when making decisions.

Table 2. Examples of Impact of Changes in Accounting Policies and Estimates on Financial Statements

Change Type	**Example**	**Impact on Financial Statements**
Change in Accounting Policy	Change from FIFO to LIFO for inventory	Affects COGS, gross profit, net income, inventory valuation, and equity
Change in Accounting Estimate	Revision of asset useful life	Alters depreciation expense, net income, and carrying value of the asset
Change in Accounting Policy	New revenue recognition method	Affects revenue, accounts receivable, net income, and retained earnings
Change in Accounting Estimate	Increase in allowance for doubtful accounts	Increases bad debt expense, reduces accounts receivable and net income

Source: developed by the author based on Wahlen et al. (2018)

Modifications in accounting policies can greatly influence financial statements by changing the methods used to record and report financial transactions and events. Such adjustments can have repercussions on essential elements of the financial statements, such as assets, liabilities, equity, revenue, and expenses.

- **Impact on Profit and Loss**: When an organization alters its accounting policy, it may necessitate retrospective adjustments to its income statement. This involves recalculating prior revenues, expenses, and net income in accordance with the new policy. For instance, switching from the First-In, First-Out (FIFO) method to the Last-In, First-Out (LIFO) method for inventory valuation can change the cost of goods sold (COGS), which in turn affects both gross profit and net income. Such alterations can have a significant effect on profitability ratios and earnings per share (EPS), thereby influencing how investors perceive the organization's performance.
- **Impact on Assets and Liabilities**: Adjustments in accounting policies can also have repercussions for the balance sheet. For example, the adoption of a new revenue recognition policy might lead to the earlier or later recording of accounts receivable and associated revenue. This can change the reported current assets and affect the entity's liquidity. Additionally, shifts in policies regarding the capitalization or expensing of costs—such as those related to research and development—can influence the total assets and equity reported on the balance sheet.
- **Impact on Equity**: Changes in accounting policies frequently necessitate adjustments to retained earnings. When a policy change is applied retrospectively, modifications are made to the opening balance of retained earnings for the earliest period presented. This can affect the entity's equity and book value, which are essential metrics for shareholders and potential investors.

Adjustments to accounting estimates are implemented on a prospective basis, meaning they have an immediate impact on the financial statements for the current period as well as for future periods.

- **Impact on Income Statement**: Modifications to accounting estimates, such as adjusting the useful life of a depreciable asset or changing the estimated percentage of uncollectible accounts, can influence the expenses recorded in the income statement. For instance, lengthening the useful life of an asset will lead to a decrease in annual depreciation expense, resulting in an increase in net income

in subsequent periods. On the other hand, raising the allowance for doubtful accounts will result in higher bad debt expenses, which will decrease net income.

- **Impact on Assets and Liabilities**: Estimates concerning asset impairments, provisions, and allowances can have a substantial impact on the balance sheet. For example, if the estimated fair value of a long-lived asset is revised downward due to impairment, the carrying value of that asset will decrease, which affects both total assets and equity. Additionally, adjustments to estimates for provisions, such as warranty liabilities or restructuring costs, will change the reported liabilities and subsequently affect the entity's financial position.
- **Impact on Cash Flows**: Changes in accounting estimates can also indirectly impact the cash flow statement. For instance, modifications to depreciation methods and useful lives can influence non-cash expenses, thus affecting cash flow from operating activities. While the cash flow from operations may not change significantly, the perception of the entity's cash-generating ability could be influenced by how changes in estimates impact reported profitability.

3. Conclusions

Adjustments to accounting policies and estimates are essential for ensuring that financial reporting reflects the changing realities of business and economic conditions. Such changes help ensure that financial statements accurately and faithfully represent an organization's financial situation and performance. Nevertheless, the effects of these modifications are contingent upon the quality of the disclosures made. When implemented effectively, these changes improve the relevance and reliability of financial reports, offering stakeholders clearer insights into the organization's financial well-being.

- **Timely Adjustments**: Adjustments to estimates, including those related to depreciation or provisions, should be initiated in a timely manner to reflect changes in business circumstances or new information. Such proactive adjustments enhance the congruence between financial statements and real economic events.
- **Transparency and Clarity**: It is essential for organizations to provide clear disclosures regarding the nature, rationale, and implications of changes in accounting policies or estimates to maintain stakeholder trust. Organizations should communicate in a straightforward, detailed, and comprehensible manner, enabling stakeholders to accurately assess the effects of these changes.

Adjustments to accounting policies and estimates are crucial for ensuring that financial reporting remains accurate and relevant. Although these modifications can result in considerable alterations to financial statement results, they are necessary to ensure that these statements accurately depict the current state of the business and adhere to changing accounting standards. For stakeholders, grasping the reasons for these changes and their potential effects is vital for making well-informed decisions.

Organizations should emphasize the importance of transparency and consistency in their disclosures, making certain that all stakeholders—including investors, creditors, auditors, and regulators—receive the necessary information to accurately evaluate the entity's financial status and performance. As the landscape of financial reporting evolves, these organizations must be adaptable, ensuring that their accounting practices align with regulatory changes and the ever-changing global market conditions.

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