2009

IFRS Foundation: Training Material for the *IFRS*® *for SMEs*

Module 10 – Accounting Policies, Estimates and Errors

IFRS™

IFRS Foundation: Training Material for the *IFRS® for SMEs*

including the full text of
Section 10 *Accounting Policies, Estimates and Errors*
of the International Financial Reporting Standard (IFRS)
for Small and Medium-sized Entities (SMEs)
issued by the International Accounting Standards Board on 9 July 2009

with extensive explanations, self-assessment questions and case studies

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This training material has been prepared by IFRS Foundation education staff. It has not been approved by the International Accounting Standards Board (IASB). The training material is designed to assist those training others to implement and consistently apply the *IFRS for SMEs*. For more information about the IFRS education initiative visit http://www.ifrs.org/Use+around+the+world/Education/Education.htm.

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Module 10 – Accounting Policies, Estimates and Errors

This training material has been prepared by IFRS Foundation education staff and has not been approved by the International Accounting Standards Board (IASB). The accounting requirements applicable to small and medium-sized entities (SMEs) are set out in the *International Financial Reporting Standard (IFRS) for SMEs*, which was issued by the IASB in July 2009.

INTRODUCTION

This module focuses on the accounting and reporting of accounting policies, estimates and errors in accordance with Section 10 *Accounting Policies, Estimates and Errors* of the *IFRS for SMEs*. It introduces the learner to the subject, guides the learner through the official text, develops the learner's understanding of the requirements through the use of examples and indicates significant judgements that are required in applying Section 10. Furthermore, the module includes questions designed to test the learner's knowledge of the requirements and case studies to develop the learner's ability to account for changes in accounting policies, changes in accounting estimates and the correction of prior period errors in accordance with the *IFRS for SMEs*.

Learning objectives

Upon successful completion of this module you should know the financial reporting requirements for accounting policies, estimates and errors in accordance with the *IFRS for SMEs*. Furthermore, through the completion of case studies that simulate aspects of the real world application of that knowledge, you should have enhanced your ability to account for accounting policies, estimates and errors in accordance with the *IFRS for SMEs*. In particular you should, in the context of the *IFRS for SMEs*, be able:

- to distinguish between the following: a change in accounting estimate, the correction of a prior period error and a change in accounting policy
- to develop an accounting policy for a transaction, other event or condition not specifically addressed in the *IFRS for SMEs*
- to disclose accounting policies and account for and disclose a change in accounting policy in financial statements (including demonstrating an understanding of the adjustments required under retrospective application and prospective application of an accounting policy)
- to account for and disclose a change in accounting estimate in financial statements
- to account for and disclose the correction of a prior period error in financial statements
- to demonstrate an understanding of the significant judgements that are required in making estimates and in determining and applying accounting policies.

Module 10 – Accounting Policies, Estimates and Errors

IFRS for SMEs

The *IFRS for SMEs* is intended to apply to the general purpose financial statements of entities that do not have public accountability (see Section 1 *Small and Medium-sized Entities*).

The *IFRS for SMEs* includes mandatory requirements and other material (non-mandatory) that is published with it.

The material that is not mandatory includes:

- a preface, which provides a general introduction to the *IFRS for SMEs* and explains its purpose, structure and authority.
- implementation guidance that includes illustrative financial statements and a disclosure checklist.
- the Basis for Conclusions, which summarises the IASB's main considerations in reaching its conclusions in the *IFRS for SMEs*.
- the dissenting opinion of an IASB member who did not agree with the publication of the *IFRS for SMEs*.

In the *IFRS for SMEs* the Glossary is part of the mandatory requirements.

In the *IFRS for SMEs* there are appendices in Section 21 *Provisions and Contingencies*, Section 22 *Liabilities and Equity* and Section 23 *Revenue.* Those appendices are non-mandatory guidance.

Introduction to the requirements

The objective of general purpose financial statements of a small or medium-sized entity is to provide information about the entity's financial position, performance and cash flows that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs. The objective of Section 10 is to prescribe the criteria for selecting and changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and corrections of prior period errors.

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

Once an entity has adopted an accounting policy for a specific type of transaction, other event or condition, it should change that policy only if the *IFRS for SMEs* is amended or the entity concludes that a new policy results in reliable and more relevant information.

Except in circumstances specified in the *IFRS for SMEs*, all changes in accounting policies and corrections of prior period errors are accounted for retrospectively. This means that comparative information in financial statements is restated to reflect transactions and events in accordance with the new accounting policy as if that policy had always been applied, and that prior period errors are corrected in the period in which they occurred. Retrospective application of accounting policies and retrospective restatement of prior period errors enhances the relevance and reliability of an entity's financial statements by making them comparable over time and with the financial statements of other entities.

Prior period errors are omissions from, and misstatements in, the entity's financial statements for one or more prior periods. They arise from a failure to use reliable information that was available when financial statements for those periods were authorised for issue, provided that such information could reasonably be expected to have been obtained and used in the preparation and presentation of those financial statements. They also arise from the misuse of such information.

A change in accounting estimate is an adjustment that results from assessing the present status of, and expected future benefits and obligations associated with, assets and liabilities. The adjustment may be to the carrying amount of an asset or a liability, or the expense that reflects the consumption of the asset. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

Changes in accounting estimates are, except in clearly defined circumstances, applied prospectively. This means that the effect of a change is included in profit or loss in the period of the change, if the change affects that period only, and in the period of the change and future periods if the change affects both.

Disclosure requirements for accounting policies and information about key sources of estimation uncertainty are set out in Section 8 *Notes to the Financial Statements* (see paragraphs 8.5–8.7). Disclosure requirements for changes in accounting policies are set out in Section 10.

Module 10 – Accounting Policies, Estimates and Errors

REQUIREMENTS AND EXAMPLES

The contents of Section 10 *Accounting Policies, Estimates and Errors* of the *IFRS for SMEs* are set out below and shaded grey. Terms defined in the Glossary of the *IFRS for SMEs* are also part of the requirements. They are in **bold type** the first time they appear in the text of Section 10. The notes and examples inserted by the IFRS Foundation education staff are not shaded. Other annotations inserted by the IFRS Foundation staff are presented within square brackets in ***bold italics***. The insertions made by the staff do not form part of the *IFRS for SMEs* and have not been approved by the IASB.

Scope of this section

10.1 This section provides guidance for selecting and applying the **accounting policies** used in preparing **financial statements**. It also covers **changes in accounting estimates** and corrections of **errors** in prior period financial statements.

Selection and application of accounting policies

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

10.3 If this IFRS specifically addresses a transaction, other event or condition, an entity shall apply this IFRS. However, the entity need not follow a requirement in this IFRS if the effect of doing so would not be **material**.

Notes

Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users made on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, is the determining factor (see paragraph 3.16).

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 (see paragraph 2.4). The providers of risk capital (an important user group) are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. Shareholders are also interested in information that enables them to assess the entity's ability to pay dividends. Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of such users made on the basis of the financial statements (see paragraph 2.6).

The definition of material implies that an entity need not provide a specific disclosure required by this IFRS if the information is not material. Moreover, an entity need not apply its accounting policies when the effect of not applying them is immaterial.

Examples – *IFRS for SMEs* addresses a transaction, event or condition

Ex 1 **Contrary to the requirements of Section 20 *Leases*, a manufacturing entity does not capitalise finance leases that it enters into as a lessee. The entity accounts for all leases (ie operating leases and finance leases) in accordance with the requirements of paragraphs 20.15 and 20.16 (ie the requirements for operating leases). The only finance lease that the entity has ever entered into is for the use of a photocopying machine with a fair value of CU1,000[(1)] at the inception of the lease (in 20X8 the current reporting period). At the end of the current reporting period, the carrying amount of the entity's property, plant and equipment exceeds CU90,000,000 and its liabilities exceed CU40,000,000. For the year ended 31 December 20X8, the entity reported profit of CU30,000,000.**

The effect of not capitalising the finance lease is probably not material—it is highly unlikely that an error of this magnitude could influence the economic decisions of users made on the basis of the financial statements. Whilst the effect of the entity's accounting policy for finance leases is not material, the entity need not capitalise the finance lease.

Ex 2 **Contrary to the requirements of Section 20 *Leases* an executive jet operator does not capitalise finance leases that it enters into as a lessee. The entity sole business is operating two executive jet airplanes, both of which it leases under a finance lease. The entity accounts for all leases (ie operating leases and finance leases) in accordance with the requirements of paragraphs 20.15 and 20.16 (ie the requirements for operating leases).**

The effect of not capitalising finance leases could influence the economic decisions of users made on the basis of the financial statements. Therefore, the entity must adopt an accounting policy of capitalising finance leases in accordance with the requirements of Section 20.

Ex 3 **The facts are the same as in example 1. However, in this example, the entity also enters into many other individually immaterial finance leases.**

The effect of not capitalising finance leases must be assessed on a collective basis—if when considered collectively, they could influence the economic decisions of users made on the basis of the financial statements, then the effect is material and the entity must adopt an accounting policy of capitalising finance leases in accordance with the requirements of Section 20.

However, if it is highly unlikely that the collective effect of not capitalising the finance leases could influence the economic decisions of users made on the basis of the financial statements, then the entity need not follow an accounting policy of capitalising finance lease.

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(1) In this example, and in all other examples in this module, monetary amounts are denominated in 'currency units (CU)'.

Ex 4 **To lease an item of factory equipment, a lessee used the services of an agency to find a suitable lessor. The lease is a finance lease. The *IFRS for SMEs* does not specifically mention agency fees on leases. However, it does discuss initial direct costs that the lessee incurs.**

The entity's home country, which has a conceptual framework that it regards as similar to the IASB's, requires such agency fees to be recognised as an expense immediately.

May the entity look to its national accounting standard in developing its accounting policy?

No. The agency fees are a type of initial direct costs of the lessee (incremental costs that are directly attributable to negotiating and arranging a lease). Paragraph 20.9 requires any initial direct costs to be added to the amount recognised as an asset. Unless the effect of following the entity's national standard is immaterial, it conflicts with the requirements of paragraph 10.3.

10.4 If this IFRS does not specifically address a transaction, other event or condition, an entity's 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, *[Refer: paragraph 2.5]* and

(b) **reliable** *[Refer: paragraph 2.7]*, 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; ***[Refer: paragraph 2.8]***

(iii) are neutral, ie free from bias;

(iv) are prudent; ***[Refer: paragraph 2.9]*** and

(v) are complete ***[Refer: paragraph 2.10]*** in all material ***[Refer: paragraph 2.3]*** respects.

10.5 In making the judgement described in paragraph 10.4, management shall refer to, and consider the applicability of, the following sources in descending order:

(a) the requirements and guidance in this IFRS dealing with similar and related issues, and

(b) the definitions, **recognition** criteria and **measurement** concepts for assets, liabilities, income and expenses and the pervasive principles in Section 2 *Concepts and Pervasive Principles*.

10.6 In making the judgement described in paragraph 10.4, management may also consider the requirements and guidance in **full IFRSs** dealing with similar and related issues.

Notes

When the *IFRS for SMEs* does not specifically address a transaction, other event or condition, an entity must select an accounting policy that results in relevant and reliable information. In making that judgement, an entity considers, first, the requirements and guidance in the *IFRS for SMEs* dealing with similar and related issues and, second, the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses and the pervasive principles in Section 2 *Concepts and Pervasive Principles.* If that does not provide guidance, the entity may look to the requirements and guidance in full IFRSs, including Interpretations of IFRSs, dealing with similar and related issues (Refer: Basis for Conclusions paragraph BC86).

Example – developing an accounting policy

Ex 5 **On 1 January 20X7, as part of a scheme to provide support for projects to help rural communities, a non-government development agency announced a plan whereby during 20X7–20X9 entities can apply for a grant to set up farming operations in a specified rural area. Qualifying entities will receive an upfront cash payment of CU50,000 to set up farming operations in the specified area. Entities must complete an application form, submit their proposal and provide specified documents which the development agency will consider before issuing the grant.**

The *IFRS for SMEs* does not specify how to account for a grant from a non-government development agency. However, it does specify how to account for government grants (see Section 24 *Government Grants*). By analogy, grants received from non-government development agencies should be accounted for in accordance with the requirements of Section 24 (ie the entity should determine its accounting policy for grants from non-government development agencies in accordance with the requirements of Section 24).

Consistency of accounting policies

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

Examples – consistency of accounting policies

Ex 6 **An entity's accounting policy is to measure investments in jointly controlled entities using the fair value model. However, it is unable to determine the fair value of its investment in one of its jointly controlled entities (JV B). Therefore it measures its investment in JV B using the cost model.**

The entity's accounting policy is acceptable. Section 15 *Investments in Joint Ventures* requires an entity to account for all of its investments in jointly controlled entities using one of the following: (i) the cost model in paragraph 15.10; (ii) the equity method in paragraph 15.13; or (iii) the fair value model in paragraph 15.14. An entity that opts to use the fair value model must measure all of its investments in jointly controlled entities after initial recognition at fair value. However, the entity should use the cost model for any investment in a jointly controlled entity for which it is impracticable to measure fair value reliably without undue cost or effort (see paragraph 15.15).

Ex 7 **An entity's accounting policy is to measure investments in associates using the fair value model. However, it is unable to determine the fair value of its investment in one of its associates (associate B). Therefore, it measures its investment in associate B using the cost model.**

The entity's accounting policy is acceptable. Section 14 *Investments in Associates* requires an entity to account for all of its investments in associates using one of the following: (i) the cost model in paragraph 14.5; (ii) the equity method in paragraph 14.8; or (iii) the fair value model in paragraph 14.9. An entity that opts to use the fair value model must measure all of its investments in associates after initial recognition at fair value. However, the entity should use the cost model for any investment in an associate for which it is impracticable to measure fair value reliably without undue cost or effort (see paragraph 14.10).

Ex 8 **An entity's accounting policy is to measure investments in associates using the cost model. However, because the equity instruments of one of its associates (associate C) are listed on the national securities exchange, it measures its investment in associate C using the fair value model. Therefore it measures its investment in associate B using the cost model.**

The entity's accounting policy is acceptable. Section 14 *Investments in Associates* requires an entity to account for all of its investments in associates using one of the following: (i) the cost model in paragraph 14.5; (ii) the equity method in paragraph 14.8; or (iii) the fair value model in paragraph 14.9. An entity that opts to use the cost model must measure all of its investments in associates after initial recognition at cost less any accumulated impairment losses (see paragraph 14.5). However, the entity must use the fair value model for its investment in an associate for which there is a published price quotation (see paragraph 14.7).

Ex 9 **An entity's accounting policy is to measure its investments in associates using the fair value model. The entity follows an accounting policy of measuring its investments in jointly controlled entities using the cost model. None of the entity's investments are traded in a public securities market.**

The entity's accounting policies are acceptable. Its accounting policy for investments in associates need not be the same as its accounting policy for investments in jointly controlled entities.

Module 10 – Accounting Policies, Estimates and Errors

Changes in accounting policies

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

(a) is required by changes to this IFRS, 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.

Examples – change in accounting policies

Ex 10 **An entity that measures its investments in associates after initial recognition using the cost model changes its accounting policy to adopt the fair value model because its management believes that measurement at fair value provides more relevant information.**

The entity's change in accounting policy is acceptable. Using the fair value model to measure investments in associates results in the financial statements providing reliable and more relevant information about the effects of its investments in associates on the entity's financial position, financial performance or cash flows.

Ex 11 **An entity changes from presenting a classified statement of financial position (current and non-current assets and current and non-current liabilities shown as separate classifications) to a liquidity presentation (items presented in order of liquidity without current/non-current classification) because, in the entity's particular circumstances, a liquidity presentation provides information that is reliable and more relevant (see paragraph 4.4). The entity restated its statement of financial position for the comparable prior period because it regarded the change to a liquidity presentation as a change in accounting policy.**

The entity's treatment is correct. Accounting policies include not only the principles for recognising and measuring assets, liabilities, income and expenses but also the principles and practices for presenting them in financial statements. Current/non-current versus liquidity presentation is an example. Retrospective restatement is required.

10.9 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.

(b) the application of a new accounting policy for transactions, other events or conditions that did not occur previously or were not material.

(c) a change to the cost model when a reliable measure of fair value is no longer available (or vice versa) for an asset that this IFRS would otherwise require or permit to be measured at fair value.

Examples – not a change in accounting policy

Ex 12 **An entity acquired an investment in an associate in the current reporting period and adopted the cost model to measure the investment in associate after initial recognition. It had never before held an investment in an associate.**

The adoption of the cost model to measure its first investment in an associate does not constitute a change in accounting policy. The accounting policy is for a transaction in which the entity had not previously engaged.

Ex 13 **An entity acquired an investment in an associate in the current reporting period and adopted the fair value model to measure its investment in associate after initial recognition. Before this investment the entity accounted for its sole other investment in an associate as an item of inventory. Management justified the treatment of its investment in this associate as inventory because its cost (and value) was immaterial to the entity's financial statements.**

Provided that the original investment in associate was immaterial to the entity's financial statements, the use of the fair value model for the measurement of all of its investments in associates is not a change in accounting policy. The accounting policy is for a transaction that was previously not material. Refer also to paragraph 10.3.

Ex 14 **In the current reporting period, when a reliable measure of the fair value of an entity's only investment property became available, the entity transferred its sole investment property from property, plant and equipment (where it was accounted for using the cost-depreciation-impairment model) to investment property measured using the fair value model.**

The transfer of the investment property from property, plant and equipment (using the cost-depreciation-impairment model) to investment property measured using the fair value model, is a change in circumstances. It is not a change in accounting policy (see paragraph 16.8 of Section 16 *Investment Property*).

Ex 15 **In the current reporting period, when an entity began redeveloping its previously owner-occupied building to rent out to tenants under operating leases, it transferred the property from property, plant and equipment (where it was accounted for using the cost-depreciation-impairment model) to investment property measured using the fair value model.**

The transfer of the property from property, plant and equipment (using the cost-depreciation-impairment model) to investment property measured using the fair value model, is a change in use of the property. It is not a change in accounting policy.

Ex 16 **An entity whose functional currency became hyperinflationary in the current reporting period applied Section 31 *Hyperinflation* in preparing and presenting its financial statements, for the first time, in the current reporting period.**

The application of Section 31, for the first time, in preparing and presenting the financial statements is not a change in accounting policy; it is a change in the entity's circumstances. The new accounting policy is for a condition that did not occur previously.

Note, although the application of Section 31 for the first time is not a change in accounting policy, the restatement process required by Section 31 (paragraphs 31.3 and 31.4) is similar to the process required for retrospective application of a change in accounting policy.

10.10 If this IFRS allows a choice of accounting treatment (including the measurement basis) for a specified transaction or other event or condition and an entity changes its previous choice, that is a change in accounting policy.

Notes

An entity can change its accounting policy voluntarily only if 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 (see paragraph 10.8(b)).

Applying changes in accounting policies

10.11 An entity shall account for changes in accounting policy as follows:

(a) an entity shall account for a change in accounting policy resulting from a change in the requirements of this IFRS in accordance with the transitional provisions, if any, specified in that amendment;

(b) when an entity has elected to follow IAS 39 *Financial Instruments: Recognition and Measurement* instead of following Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues* as permitted by paragraph 11.2, and the requirements of IAS 39 change, the entity shall account for that change in accounting policy in accordance with the transitional provisions, if any, specified in the revised IAS 39; and

(c) an entity shall account for all other changes in accounting policy **retrospectively** (see paragraph 10.12).

Examples – applying changes in accounting policies

Ex 17 **In the current reporting period the entity was required to comply with an amendment to the *IFRS for SMEs*. The transitional provisions in the amended *IFRS for SMEs* required the change in accounting policy to be accounted for as an adjustment to retained earnings at the beginning of the current reporting period. The entity calculated that CU80,000 of the CU100,000 decrease in retained earnings at the beginning of the current reporting period, resulting from the change in accounting policy, is attributable to years before the comparative reporting period.**

Paragraph 10.11(a)–(c) does not provide 'free choices' but rather a sequential hierarchy of how to account for changes in accounting policy. Paragraph 10.11(a) requires the entity to follow the transitional provisions of the amended *IFRS for SMEs* (ie the effect of the change in accounting policy is presented as a restatement of retained earnings at the beginning of the current reporting period—a decrease of CU100,000 and the comparative figures are not be restated).

Ex 18 **In compliance with the only option in the *IFRS for SMEs* to use full IFRSs, an entity applies the requirements of IAS 39 *Financial Instruments: Recognition and Measurement*. In the current reporting period IAS 39 was amended. The transitional provisions for the amendment required the change in accounting policy to be accounted for as an adjustment to retained earnings at the beginning of the current reporting period. The entity calculated that CU80,000 of the CU100,000 decrease in retained earnings at the beginning of the current reporting period, as a result of the change in accounting policy, is attributable to years before the comparative reporting period.**

The effect of the change in accounting policy must be presented as a restatement of retained earnings at the beginning of the current reporting period—a decrease of CU100,000. In accordance with the transitional provisions specified in the amendment to IAS 39 the comparative figures must not be restated.

Ex 19 **In the current reporting period an entity voluntarily changed an accounting policy. The cumulative effect of the change in accounting policy on the retained earnings of the entity was a decrease of CU100,000 at the beginning of the current reporting period, CU80,000 of which was attributable to years before the comparative reporting period.**

In accordance with paragraph 10.11(c) the effect of the change in accounting policy must be presented as a restatement of retained earnings at the beginning of the comparative reporting period (a decrease of CU80,000) and CU20,000 decrease in the profit for the comparative period. The cumulative effect of these restatements is a decrease of CU100,000 in retained earnings at the beginning of the current reporting period.

Retrospective application

10.12 When a change in accounting policy is applied retrospectively in accordance with paragraph 10.11, the entity shall apply the new accounting policy to comparative information for prior periods to the earliest date for which it is practicable, as if the new accounting policy had always been applied. When it is **impracticable** to determine the individual-period effects of a change in accounting policy on comparative information for one or more prior periods presented, 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.

Notes

It is impracticable to apply a requirement if the entity cannot apply it after making every reasonable effort to do so.

'Impracticable' is a high hurdle. For a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively if:

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

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

(c) the retrospective application 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 authorised for issue

from other information.

Examples – retrospective application

Ex 20 **In 20X7, the entity voluntarily changed an accounting policy. In accordance with paragraph 10.11(c) the entity must account for the change in accounting policy retrospectively. The cumulative effect of the change in accounting policy is a decrease of CU100,000 in retained earnings at 1 January 20X7—the beginning of the current reporting period. The entity presents two years of comparative information and has calculated that the effect of the change in accounting policy is CU25,000 less profit for each of the past four years.**

The effect of the change in accounting policy must be presented as a restatement of: retained earnings at 1 January 20X5—reduced by CU50,000; profit for the year ended 31 December 20X5—reduced by CU25,000; and profit for the year ended 31 December 20X6—reduced by CU25,000. The cumulative effect of these restatements is a CU100,000 downward restatement of retained earnings at 1 January 20X7 (the beginning of the current reporting period).

Ex 21 **The facts are the same as in example 20. However, in this example, because retrospective application requires significant estimates of amounts and it is not possible to distinguish objectively information about those estimates, it is impracticable for the entity to determine the individual period effects of the change in accounting policy on the prior periods presented.**

The effect of the change in accounting policy must be presented as a CU100,000 downward restatement of retained earnings at 1 January 20X7 (the beginning of the current reporting period). The entity would disclose the information required in paragraph 10.14(d).

Ex 22 **The facts are the same as in example 21. However, in this example, assume that it is impracticable for the entity to determine the individual period effects of the change in accounting policy on the periods before 20X6.**

The effect of the change in accounting policy must be presented as a restatement of retained earnings at 1 January 20X6—reduced by CU75,000—and profit for the year ended 31 December 20X6—reduced by CU25,000. The cumulative effect of these restatements is a CU100,000 downward restatement of retained earnings at 1 January 20X7 (the beginning of the current reporting period). The entity does not restate the (comparative) information presented for the year ended 31 December 20X5 because it is impracticable to do so.

Ex 23 **The facts are the same as in example 21. However, in this example, assume that the entity would be required to engage an outside valuer to determine the individual period effects of the change in accounting policy on the prior periods presented. The entity decides that, because of the cost that would be involved in engaging the outside valuer, it is impracticable to determine the individual period effects of changing an accounting policy for one or more prior periods presented. Therefore it adjusts the opening balance of retained earnings of the period in which the accounting policy is changed for the entire cumulative effect of the change in accounting policy.**

The cost of engaging an outside valuer does not make restatement of prior periods impracticable (as that term is defined in the *IFRS for SMEs*). The prior periods must be restated.

Disclosure of a change in accounting policy

[Refer also: paragraph 8.5]

10.13 When an amendment to this IFRS has an effect on the current period or any prior period, or might have an effect on future periods, an entity shall disclose the following:

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

(b) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment for each financial statement line item affected.

(c) the amount of the adjustment relating to periods before those presented, to the extent practicable.

(d) an explanation if it is impracticable to determine the amounts to be disclosed in (b) or (c) above.

Financial statements of subsequent periods need not repeat these disclosures.

Example – disclosure of a change in accounting policy

Ex 24 **In 20X2, the entity was required to comply with an amendment to the *IFRS for SMEs*. The cumulative effect of the change in accounting policy on the retained earnings of the entity at the beginning of 20X1 is a CU80,000 decrease. The effect on profit before tax for 20X1 is a CU25,000 decrease, with a resultant decrease in income tax expense of CU5,000.**

Extract from SME A statement of income and retained earnings for the year ended 31 December 20X2

	Notes	20X2	20X1
			Restated
		CU	CU
Profit before tax (20X1: previously stated CU185,000)		200,000	160,000
Income tax expense (20X1: previously stated CU45,000)		(50,000)	(40,000)
Profit for the year (20X1: previously stated CU140,000)		150,000	120,000
Retained earnings at the beginning of the year		320,000	200,000
- as previously stated		420,000	280,000
- effect of the change in accounting policy	12	(100,000)	(80,000)
Retained earnings at the end of the year		470,000	320,000

SME A
Notes to the financial statements for the year ended 31 December 20X2

Note 12 Change in accounting policy

In 20X2 in accordance with an amendment to Section X ... of the *IFRS for SMEs* the entity changed its accounting policy for .... Previously, the entity had .... The entity now .... This change in accounting policy has been accounted for retrospectively, and the comparative information for 20X1 has been restated. The effect of the change is a reduction of CU20,000 in profit for the year ended 31 December 20X1. Furthermore, opening retained earnings for 20X1 have been reduced by CU80,000, which is the amount of the adjustment relating to periods before 20X1.

Note: The effect of the restatement on the statement of financial position (and other statements) must also be presented.

10.14 When a voluntary change in accounting policy has an effect on the current period or any prior period, an entity shall disclose the following:

(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) to the extent practicable, the amount of the adjustment for each financial statement line item affected, shown separately:

(i) for the current period;

(ii) for each prior period presented; and

(iii) in the aggregate for periods before those presented.

(d) an explanation if it is impracticable to determine the amounts to be disclosed in (c) above.

Financial statements of subsequent periods need not repeat these disclosures.

Example – voluntary change in accounting policy

Ex 25 **In 20X2, the entity voluntarily changed its accounting policy for … from … to…. The cumulative effect of the change in accounting policy on the retained earnings of the entity at the beginning of 20X1 is a CU80,000 decrease. The effect on profit before tax for the 20X1 is a CU25,000 decrease, with a resultant decrease in income tax expense of CU5,000.**

Extract from statement of income and retained earnings for the year ended 31 December 20X2

	Notes	*20X2*	*20X1*
			Restated
		CU	*CU*
Profit before tax (20X1: previously stated CU185,000)		200,000	160,000
Income tax expense (20X1: previously stated CU45,000)		(50,000)	(40,000)
Profit for the year (20X1: previously stated CU140,000)		150,000	120,000
Retained earnings at the beginning of the year		320,000	200,000
- as previously stated		420,000	280,000
- effect of the change in accounting policy	12	(100,000)	(80,000)
Retained earnings at the end of the year		470,000	320,000

SME A
Notes to the financial statements for the year ended 31 December 20X2

Note 12 Change in accounting policy

In 20X2, the entity voluntarily changed its accounting policy for …. Previously, the entity had …. The entity now …. Management judges that this policy provides reliable and more relevant information because …. This change in accounting policy has been accounted for retrospectively, and the comparative information for 20X1 has been restated. The effect of the change is a reduction of CU20,000 in profit for the year ended 31 December 20X1. Furthermore, opening retained earnings for 20X1 have been reduced by CU80,000, which is the amount of the adjustment relating to periods before 20X1.

Note: The effect of the restatement on the statement of financial position (and other statements) must also be presented.

Changes in accounting estimates

10.15 A change in accounting estimate is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors. 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.

Examples – change in accounting estimate

Ex 26 **An entity provides warranties at the time of sale to purchasers of its products. On 31 December 20X5 an entity assessed its warranty obligation for products sold before 31 December 20X5 at CU100,000. Immediately before the 31 December 20X5 annual financial statements were approved for issue the entity discovered a latent defect in one of its products (ie a defect that was not discoverable by reasonable or customary inspection). As a result of the discovery the entity revised its estimate of its warranty obligation at 31 December 20X5 to CU150,000.**

This is the determination of an (initial) accounting estimate, not a change in accounting estimate. At 31 December 20X5 the obligation for the warranty provision must be measured at CU150,000. The latent defect is a condition that existed at the end of the reporting period and is therefore taken into account in determining the amount of the obligation at the end of the reporting period even though the information was discovered later (see paragraphs 32.1–32.5).

Ex 27 **The facts are the same as in example 26. However, in this example, the latent defect was discovered when preparing the interim financial report for the six-month period ended 30 June 20X6, after the 31 December 20X5 annual financial statements were approved for issue. In July 20X6 the entity paid CU150,000 to transfer the obligation to an independent third party.**

The additional CU50,000 obligation (not provided for at 31 December 20X5) is a change in accounting estimate for the year ended 31 December 20X6. The warranty obligation (provision) was appropriately measured and reported at CU100,000 in the entity's 31 December 20X5 annual financial statements. This estimate was found to be incorrect in 20X6, after the 20X5 financial statements were approved for issue. The CU50,000 is recognised as an expense in determining the profit or loss for the six-month period ended 30 June 20X6 (see paragraph 10.16).

Ex 28 **An entity acquired a yacht for CU1,000,000 on 1 January 20X1 and appropriately assessed its useful life at 30 years from the date of acquisition with a residual value of CU100,000. The entity decided that the straight-line method is the most appropriate method on which to depreciate the yacht.**

In 20X9 the entity undertook substantial research into the yachting industry. As a result, at 31 December 20X9 the entity assessed the useful life of the yacht at

20 years from the date of acquisition with a residual value of nil. It also assessed a fair value for the yacht as at 31 December 20X9 at CU800,000. It continued to believe that the straight-line method the most appropriate method of depreciation for the yacht.

The reassessment of the yacht's useful life and its residual value are changes in accounting estimates. The revised assessments are appropriately made on the basis of new information that arose from research performed in the current reporting period—20X9. See example 32 for the accounting entries.

Ex 29 **The facts are the same as in example 28. However, the research was undertaken by an independent third party and has been publicly available since late 20X5. Although the entity believed the research to be valid it chose to ignore the research findings until 20X9.**

The reassessment in 20X9 of the yacht's useful life and its residual value are not changes in accounting estimates. They represent prior period errors in the entity's financial information since 20X5. The financial statements must be restated to correct the effects of the errors in the periods to which they relate [if material].

Ex 30 **An entity has been depreciating its buildings over a 25-year life, which is what is allowed by the entity's national tax laws. In the current year, the tax law is changed to allow depreciation of buildings over 20 years. The entity makes this change for financial reporting purposes and treats it as a change in accounting estimate.**

Paragraph 17.18 requires an entity to allocate the depreciable amount of an asset on a systematic basis over its useful life. Unless the useful life of the entity's buildings actually is 25 years, the entity has not been complying properly with paragraph 17.18, which requires the depreciable amount to be allocated over the entire period in which the entity expects to use the asset. Most buildings have useful lives significantly longer than 25 years. If the entity has not been using the correct useful life, it should treat this as the correction of an error by a retrospective restatement. Also, it should allocate the depreciable amount over the useful life, not 25 years or 20 years.

10.16 An entity shall recognise the effect of a change in an accounting estimate, other than a change to which paragraph 10.17 applies, **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.

Examples – prospective recognition

Ex 31 **At 31 December 20X1 an entity measured one of its trade debtors at CU200,000 (ie CU600,000 gross amount less CU400,000 provision for doubtful debts). The estimate of the extent of the doubtful debt was appropriately made on the basis of all of the available information.**

On 31 December 20X2 the entity received notification from the liquidator of the debtor that it would shortly receive CU250,000 in full and final settlement of the debt.

The entity must include CU50,000 (CU250,000 at 31 December 20X2 less CU200,000 at 31 December 20X1) change in accounting estimate as an increase in profit for the year ended 31 December 20X2.

Ex 32 **The facts are the same as in example 28.**

(An entity acquired a yacht for CU1,000,000 on 1 January 20X1 and appropriately assessed its useful life at 30 years from the date of acquisition with a residual value of CU100,000. The entity decided that the straight-line method is the most appropriate method on which to depreciate the yacht.

In 20X9 the entity undertook substantial research into the yachting industry. As a result, as at 31 December 20X9 the entity assessed the useful life of the yacht at 20 years from the date of acquisition with a residual value of CU500,000. It also assessed a fair value for the yacht as at 31 December 20X9 at CU800,000. It continued to believe that the straight-line method the most appropriate method of depreciation for the yacht.)

Depreciation of CU21,667 will be deducted in determining profit or loss for the year ended 31 December 20X9 and for each of the next eleven years' remaining useful life of the yacht (ie the remaining depreciable amount will be recognised as an expense evenly over the remaining useful life (12 years, including 20X9) calculated as follows (CU760,000 carrying amount less CU500,000 residual value) ÷ 12 years' remaining useful life).

Ex 33 **An entity paid a systems developer CU50,000 for an on-line system by which its customers could place orders. The entity accounted for the cost of the system as a purchased limited-life intangible asset. The entity estimated that the system would have a five-year life and amortised the cost accordingly. Unfortunately the system never worked as anticipated and customer use declined considerably after the first year because of ongoing system problems resulting in incorrect orders. After two years the entity replaced the custom-developed system with a generic software package available in the market. The entity concluded that the entire CU50,000 expenditure was worthless from the beginning and decided to write it off retrospectively, in the year of acquisition, as a correction of an error.**

Treating this as a correction of an error is not appropriate. The amortisation in the first two years in which the custom-developed system was used was based on an assessment of future benefits coming from that system. After two years, the assessment of future benefits changed. A prior period error results from failure to take into account information that was available at the time. Until the end of the second year, the best available information was that the system would provide future benefits. Therefore, this is a change of estimate, not a correction of a prior period error.

10.17 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, the entity shall recognise it by adjusting the carrying amount of the related asset, liability or equity item in the period of the change.

Disclosure of a change in estimate

[For disclosures about key sources of estimation uncertainty refer to paragraph 8.7]

10.18 An entity shall disclose the nature of any change in an accounting estimate and the effect of the change on assets, liabilities, income and expense for the current period. If it is practicable for the entity to estimate the effect of the change in one or more future periods, the entity shall disclose those estimates.

Examples – disclosure of a change in accounting estimate

Ex 34 **Consider the information in example 32.**

(An entity acquired a yacht for CU1,000,000 on 1 January 20X1 and appropriately assessed its useful life at 30 years from the date of acquisition with a residual value of CU100,000. The entity decided that the straight-line method is the most appropriate method on which to depreciate the yacht.

In 20X9, the entity undertook substantial research into the yachting industry. As a result, as at 31 December 20X9 the entity assessed the useful life of the yacht at 20 years from the date of acquisition with a residual value of CU500,000. It also assessed a fair value for the yacht as at 31 December 20X9 at CU800,000. It continued to believe that the straight-line method the most appropriate method of depreciation for the yacht.)

SME X
Notes to the financial statements for the year ended 31 December 20X9

Note 3 Operating profit

Change in accounting estimate

At 31 December 20X9, as a result of research undertaken about the yachting industry, the entity reassessed the useful life of its yacht at 20 years (previously 30 years) from the date of acquisition; and the residual value of its yacht at CU500,000 (previously CU100,000). This had the effect of decreasing the depreciation expense for the year ended 31 December 20X9 by CU8,333 (previously CU30,000 per year, now CU21,667 per year). Depreciation for each of the next 11 years is expected to be similarly affected by these changes in accounting estimates.

Note: In this example, tax effects have been ignored.

Corrections of prior period errors

10.19 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 authorised 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.

10.20 Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

Examples – prior period errors

Ex 35 **In 20X4, after the entity's 20X3 financial statements were approved for issue, the entity discovered that, as a result of a computational error, depreciation expense for 20X3 was understated by CU10.**

The CU10 understatement of depreciation expense in the 20X3 financial statements is a prior period error—the misstatement in the entity's 20X3 financial statements arose from the misuse (mathematical error) of reliable information that was available when financial statements for those periods were authorised for issue. However, it is probably not material. If so, it can be ignored.

Ex 36 **In 20X4, after the entity's 20X3 financial statements were approved for issue, the entity discovered that, as a result of a computational error, depreciation expense for 20X3 was understated by CU36,000.**

The CU36,000 understatement of depreciation expense in the 20X3 financial statements is a prior period error—the misstatement in the entity's 20X3 financial statements arose from the misuse (mathematical error) of reliable information that was available when financial statements for those periods were authorised for issue. See example 39 for details of the restatement.

Ex 37 **In 20X4, after the entity's 31 December 20X3 annual financial statements were approved for issue, a latent defect in the composition of a new product manufactured by the entity was discovered (ie a defect that was not discoverable by reasonable or customary inspection). As a result of the latent defect the entity incurred CU100,000 unanticipated costs in fulfilling its warranty obligation in respect of sales made before 31 December 20X3. An additional CU20,000 was incurred in respect of products sold in 20X4 before the latent defect was detected and the production process rectified—CU5,000 of which relates to items of inventory at 31 December 20X3. The defective inventory was reported at cost (CU15,000) in the 20X3 financial statements when its selling price less costs to complete and sell was estimated at CU18,000. The accounting estimates made in preparing the 31 December 20X3 financial statements were appropriately made using all reliable information that the entity could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.**

Neither the CU100,000 understatement of the warranty provision nor the CU2,000[2] overstatement of inventory in the 31 December 20X3 financial statements is a prior period error. The effects of the latent defect that relate to the entity's financial position at 31 December 20X3 are changes in accounting estimates (see paragraph 10.13).
In preparing its 31 December 20X3 financial statements the entity made the warranty provision and inventory valuation appropriately using all reliable information that the

[2] Inventory is measured at the lower of cost (ie CU 15,000) and fair value less costs to complete and sell (ie CU 13,000—CU18,000 originally estimated less CU5,000 costs to rectify latent defect) (see paragraph 13.4)..

entity could reasonably be expected to have obtained and taken into account in the preparation and presentation of those financial statements.

Ex 38 **An entity acquired a machine for CU140,000 on 1 January 20X0. It estimated that the machine would have a 10-year useful life, no residual value, with annual depreciation of CU14,000. Early in 20X4 (carrying amount of the machine is now CU84,000) the entity estimates that the machine has a remaining useful life of 10 years (ie measured from 1 January 20X4). The entity concludes that depreciation in years 20X0 to 20X3 should have been only CU10,000 per year (CU140,000/14 years). To correct the error, the entity restates its financial statements for those four years and discloses a correction of a prior period error.**

If the original estimate of a 10-year useful life was reasonable, this is not a correction of a prior period error but, rather, a change in accounting estimate that should be accounted for prospectively starting in 20X4. Financial statements for the prior years would not be restated. The CU84,000 carrying amount of the asset is depreciated over the 10 remaining years of useful life, with disclosure of the change in accounting estimate.

10.21 To the extent practicable, an entity shall correct a material prior period error retrospectively in the first financial statements authorised for issue after its discovery by:

(a) restating the comparative amounts for the prior period(s) presented in which the error occurred, or

(b) if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.

Notes

It is impracticable to apply a requirement if the entity cannot apply it after making every reasonable effort to do so (see Glossary).

'Impracticable' is a high hurdle. For a particular prior period, it is impracticable to determine the period-specific effects of an error on the comparative information of one or more prior periods presented if:

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

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

(c) the 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 authorised for issue from other information.

Examples – retrospective recognition

Ex 39 **The facts are the same as in example 36.**

(In 20X4, after the entity's 20X3 financial statements were approved for issue, the entity discovered that, as a result of a computational error, depreciation expense for 20X3 was understated by CU36,000.)

The effect of correcting the prior period error must be presented as a restatement of profit for the year ended 31 December 20X3, reduction of CU36,000, and a CU36,000 downward restatement of retained earnings at 1 January 20X4 (the beginning of the current reporting period).

Note: in this example, tax effects have been ignored.

Ex 40 **In 20X7 the entity discovered a programming error in its costing system that causes random errors in the costing of the entity's main product. In accordance with paragraph 10.21(b) the entity must account for the correction of the prior period error retrospectively, ie retrospective restatement. The cumulative effect of the error is a decrease of CU100,000 in retained earnings at 1 January 20X7—the beginning of the current reporting period. The entity presents two years of comparative information and has calculated that the effect of the error is CU25,000 less profit for each of the past four years.**

The effect of correcting the prior period error must be presented as a restatement of retained earnings at 1 January 20X5—reduction of CU50,000; profit for the year ended 31 December 20X5—reduction of CU25,000; and profit for the year ended 31 December 20X6—reduction of CU25,000. The effect of these restatements is a CU100,000 downward restatement of retained earnings at 1 January 20X7 (the beginning of the current reporting period).

10.22 When it is impracticable to determine the period-specific effects of an error on comparative information for one or more prior periods presented, the entity shall restate the opening balances of assets, liabilities and equity for the earliest period for which retrospective restatement is practicable (which may be the current period).

Example – impracticable to determine period-specific effects

Ex 41 **The facts are the same as in example 40.**

(In 20X7 the entity discovered a programming error in its costing system that causes random errors in the costing of the entity's main product. In accordance with paragraph 10.21(b) the entity must account for the correction of the prior period error retrospectively (ie retrospective restatement). The cumulative effect of the error is CU100,000 decrease in retained earnings at 1 January 20X7—the beginning of the current reporting period. The entity presents two years of comparative information and has calculated that the effect of the error is CU25,000 less profit for each of the past four years.)

However, in this example, assume that it is impracticable for the entity to determine the individual period effects of the error on the periods before 20X6.

The effect of correcting the prior period error must be presented as a restatement of retained earnings (and inventories—asset) at 1 January 20X6—reduced by CU75,000—and profit for the year ended 31 December 20X6—reduced by CU25,000. The effect of these restatements is a CU100,000 downward restatement of retained earnings (and inventories—asset) at 1 January 20X7 (the beginning of the current reporting period). It is impracticable to restate the (comparative) information presented for the year ended 31 December 20X5. The entity must disclose an explanation of the reasons why it is impracticable to determine the amounts to be disclosed for the period before 1 January 20X6 (see paragraph 10.23(d)).

Ex 42 **The facts are the same as in example 41. However, in this example, assume that it is impracticable for the entity to determine the individual period effects of the error on any of the prior periods presented.**

The effect of correcting the error must be presented as a downward restatement of retained earnings at 1 January 20X7 (the beginning of the current reporting period) because it is impracticable to restate the comparative information. The entity must disclose an explanation of the reasons why it is impracticable to determine the amounts to be disclosed for the period before 1 January 20X7 (see paragraph 10.23(d)).

Disclosure of prior period errors

10.23 An entity shall disclose the following about prior period errors:

(a) the nature of the prior period error.

(b) for each prior period presented, to the extent practicable, the amount of the correction for each financial statement line item affected.

(c) to the extent practicable, the amount of the correction at the beginning of the earliest prior period presented.

(d) an explanation if it is not practicable to determine the amounts to be disclosed in (b) or (c) above.

Financial statements of subsequent periods need not repeat these disclosures.

Notes

Disclosure of the correction of a prior period error must be made even when the disclosure might result in legal action against the entity. For example, an entity that discovers a prior period error must disclose the correction of that error even if it is worried that disclosure could result in a lawsuit. Similarly, if the correction of a prior period error would reveal that the entity violated its borrowing covenants, it must nevertheless be disclosed.

Example – disclosure of prior period errors

Ex 43 **In 20X2, after the entity's 20X1 financial statements were approved for issue, the entity discovered a longstanding computational error in the calculation of depreciation expense. The cumulative effect of the error on the retained earnings**

of the entity at the beginning of the 20X1 is a CU80,000 overstatement. The error resulted in profit before tax for the year ended 31 December 20X1 being overstated by CU25,000, with a resultant CU5,000 overstatement of income tax expense.

Extract from statement of income and retained earnings for the year ended 31 December 20X2

	Notes	*20X2*	*20X1*
			Restated
		CU	*CU*
Profit before tax (20X1: previously stated CU185,000)		200,000	160,000
Income tax expense (20X1: previously stated CU45,000)		(50,000)	(40,000)
Profit for the year (20X1: previously stated CU140,000)		150,000	120,000
Retained earnings at the beginning of the year		320,000	200,000
- as previously stated		420,000	280,000
- effect of the correction of a prior period error	12	(100,000)	(80,000)
Retained earnings at the end of the year		470,000	320,000

SME A
Notes to the financial statements for the year ended 31 December 20X2

Note 12 Correction of prior period error

In 20X2, the entity corrected mathematical mistakes that had resulted in the understatement of depreciation expense over the past [four] years. The correction of the error is accounted for retrospectively, and the comparative information for 20X1 has been restated. The effect of the change is a CU20,000 reduction in profit for the year ended 31 December 20X1. Furthermore, opening retained earnings for 20X1 have been reduced by CU80,000, which is the amount of the error relating to periods before 20X1.

Note: The effect of the restatement on the statement of financial position (and other statements) must also be presented.

SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS

Applying the requirements of the *IFRS for SMEs* to transactions and events often requires judgement. Information about significant judgements and key sources of estimation uncertainty is useful in assessing an entity's financial position, performance and cash flows. Consequently, in accordance with paragraph 8.6 an entity must disclose the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. Furthermore, in accordance with paragraph 8.7, an entity must disclose information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

Other sections of the *IFRS for SMEs* require disclosure of information about particular judgements and estimation uncertainties.

Accounting policies

Determining accounting policies

In many cases little difficulty is encountered in determining accounting policies. However, in some cases significant judgement is required in determining an accounting policy.
In particular, where the *IFRS for SMEs* does not specifically address a transaction, other event or condition, management must use its judgement in developing an accounting policy for that transaction, other event or condition in accordance with paragraphs 10.4 and 10.5 of the *IFRS for SMEs*. In making the judgement described in paragraph 10.4, management may consider, but is not required to do so, the requirements and guidance in full IFRSs dealing with similar and related issues.

> *Example*
> An entity has factored some of its accounts receivable with a bank. In purchasing the receivables, the bank has assumed all credit risk up to 15 per cent of the amount of the receivables. The selling entity's experience is that credit losses in its receivables have historically been less than 10 per cent. In deciding whether to account for the factoring as a sale of receivables or a collateralised borrowing, the selling entity must use its judgement to determine whether it has transferred to the bank all of the significant risks and rewards relating to the receivables (see paragraph 11.33(b)).

Applying accounting policies

In other cases management must make significant judgements in applying its accounting policies. For example, in certain circumstances, management must make judgements in determining:

- the degree of influence the entity exerts over another, eg significant influence, control etc
- whether certain properties are investment property, inventories or property, plant and

equipment

- whether, in substance, particular sales of goods are financing arrangements and therefore do not give rise to revenue
- whether the substance of the relationship between the entity and a special purpose entity indicates that the special purpose entity is controlled by the entity.

The judgements made in applying accounting policies that have the most significant effect on the amounts recognised in the financial statements must be disclosed (see paragraph 8.6).

Change of accounting policies

An entity can voluntarily change an accounting policy only if 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 (see paragraph 10.8(b)). Judgements about the relevance and reliability of information must be made before voluntarily changing an accounting policy.

When a change in accounting policy is applied retrospectively, an entity might need to judge whether it is impracticable to determine the individual period effects of changing an accounting policy for one or more prior periods presented (see paragraph 10.12). However, in making that judgement, an entity must consider that retrospective application is impracticable only when the entity cannot apply the requirement after making every reasonable effort to do so (see the definition of impracticable in the glossary). In effect the entity must assess what constitutes every reasonable effort.

Judgement might be required to distinguish a change in accounting estimate from a change in accounting policy. When it is difficult to make that distinction, the change is treated as a change in an accounting estimate (paragraph 10.15).

Accounting estimates

Accounting estimates

Determining the carrying amounts of some assets and liabilities requires estimation of the effects of uncertain future events on those assets and liabilities at the end of the reporting period. For example, in the absence of recently observed market prices, estimates are necessary to measure the residual value of property, plant and equipment and, when impairment is indicated, its recoverable amount. Other examples include the effect of technological obsolescence on inventories and the effect of the future outcome of litigation in progress on the amount of provisions. An entity must disclose in the notes information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the end of the reporting period, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year (see paragraph 8.7).

Changes in accounting estimates

When significant accounting estimates are applied in determining the carrying amount of an asset or liability it follows that those estimates will probably require adjustment as new information becomes available or new developments occur. An adjustment of the carrying amount of an asset or a liability (or the amount of the periodic consumption of an asset) that results from the assessment of the present status of, and expected future benefits and obligations associated with assets and liabilities, is a change in accounting estimate (see paragraph 10.15). Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

Judgement might be required to distinguish a change in accounting estimate from a change in accounting policy. When it is difficult to make that distinction, the change is treated as a change in an accounting estimate (see paragraph 10.15).

Correction of material prior period errors

To the extent practicable, an entity corrects a material prior period error retrospectively (see paragraph 10.21). In certain cases an entity might need to judge whether it is impracticable to determine the individual period effects of the prior period error on one or more prior periods presented (see paragraph 10.22). However, in making that judgement, an entity must consider that retrospective restatement is impracticable only when the entity cannot apply the requirement after making every reasonable effort to do so (see the definition of impracticable in the Glossary).

Module 10 – Accounting Policies, Estimates and Errors

COMPARISON WITH FULL IFRSs

Full IFRSs (see IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*) and the *IFRS for SMEs* (see Section 10 *Accounting Policies, Estimates and Errors*) as issued at 9 July 2009 share the same principles for accounting and reporting events after the end of the reporting period. However, the *IFRS for SMEs* is drafted in simple language and includes less guidance on how to apply the principles.

Module 10 – Accounting Policies, Estimates and Errors

TEST YOUR KNOWLEDGE

Test your knowledge of the requirements for accounting and reporting accounting policies, estimates and errors in accordance with the *IFRS for SMEs* by answering the questions below.

Once you have completed the test check your answers against those set out below this test.

Assume all amounts are material.

Mark the box next to the most correct statement.

Question 1

Prospective application of a change in accounting policy means:

☐ (a) applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the financial statements are authorised for issue.

☐ (b) applying the new accounting policy to transactions, other events and conditions occurring between the date as at which the policy is changed and the date when the financial statements are authorised for issue.

☐ (c) applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed.

☐ (d) applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied.

Question 2

Retrospective application of a change in accounting policy means:

☐ (a) applying a new accounting policy to transactions, other events and conditions, identified before the date when the financial statements are authorised for issue, as if that policy had always been applied.

☐ (b) applying the new accounting policy to transactions, other events and conditions occurring between the date as at which the policy is changed and the date when the financial statements are authorised for issue.

☐ (c) applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed.

☐ (d) applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied.

Question 3

Which of the following statements is true?

- ☐ (a) The effect of a change in accounting estimate is recognised retrospectively.
- ☐ (b) To the extent practicable, an entity must correct a prior period error prospectively in the first financial statements authorised for issue after its discovery.
- ☐ (c) When an entity discovers an error in its financial statements of a prior period, it must immediately withdraw those financial statements and reissue them with the error corrected.
- ☐ (d) To the extent practicable, an entity must correct a prior period error retrospectively in the first financial statements authorised for issue after its discovery.

Question 4

On 25 March 20X4 the entity discovered that, as a result of a computational error, depreciation expense for 20X3 is overstated by CU29,000. The entity's 31 December 20X3 financial statements were authorised for issue on 1 March 20X4. The entity must:

- ☐ (a) reissue its 31 December 20X3 financial statements with the correct depreciation expense.
- ☐ (b) reduce depreciation for the year ended 31 December 20X4 by CU29,000 (ie prospective allocation—a change in accounting estimate).
- ☐ (c) restate (correct) the depreciation expense reported for the year ended 31 December 20X3 in the comparative figures of its 20X4 financial statements (ie retrospective restatement of a prior period error).

Question 5

The facts are the same as in Question 4. However, the entity's 31 December 20X3 financial statements were authorised for issue on 1 April 20X4. The entity must:

- ☐ (a) correct its 31 December 20X3 financial statements before issuing them.
- ☐ (b) reduce depreciation for the year ended 31 December 20X4 by CU29,000 (ie prospective allocation—a change in accounting estimate).
- ☐ (c) restate (correct) the depreciation expense reported for the year ended 31 December 20X3 in the comparative figures of its 20X4 financial statements (ie retrospective restatement of a prior period error).

Question 6

On 20 February 20X5, before an entity's 31 December 20X4 financial statements were authorised for issue, a court ordered the entity to pay CU120,000 damages in full and final settlement of a patent infringement lawsuit brought against the entity by one of its competitors. The patent infringement occurred in 20X3. The amount of damages awarded to the competitor was significantly higher than the CU10,000–CU30,000 that the entity had justifiably expected to pay throughout the duration of the case. The entity will not contest the judgement.

In its 31 December 20X3 annual financial statements the entity reported its liability for the lawsuit at CU20,000—this estimate was appropriately made taking account of all available evidence at the time the financial statements were authorised for issue.

In its 31 December 20X4 financial statements the entity must:

☐ (a) restate the comparative information at 31 December 20X3 (ie retrospective restatement of a prior period error).

☐ (b) measure the provision at 31 December 20X4 at CU120,000 (comparative information 20X3: CU20,000), ie account prospectively for the change in accounting estimate in its 20X4 financial statements.

☐ (c) measure the provision at 31 December 20X4 at CU20,000 (comparative information 20X3: CU20,000) and record the effect of the higher than expected settlement in profit or loss for the year ended 31 December 20X5 (ie account prospectively for the change in accounting estimate in the period that the final settlement amount was determined).

Question 7

On 20 February 20X5, before an entity's 31 December 20X4 financial statements were authorised for issue, a court ordered the entity to pay CU120,000 damages in full and final settlement of a patent infringement lawsuit brought against the entity by one of its competitors. The patent infringement occurred in 20X3. The amount of damages awarded to the competitor was consistent with similar cases settled in that jurisdiction since 20X2.

In its 31 December 20X3 annual financial statements the entity reported its liability for the lawsuit at CU20,000. The entity deliberately understated the amount presented, because it did not want to make public its true estimate, believing that this would be detrimental to its defence.

In its 31 December 20X4 financial statements the entity must:

☐ (a) restate the comparative information at 31 December 20X3 (ie retrospective restatement of a prior period error).

☐ (b) measure the provision at 31 December 20X4 at CU120,000 (comparative information 20X3: CU20,000), ie account prospectively for the change in accounting estimate in its 20X4 financial statements.

☐ (c) measure the provision at 31 December 20X4 at CU20,000 (comparative information 20X3: CU20,000) and record the effect of the higher than expected settlement in profit or loss for the year ended 31 December 20X5 (ie account prospectively for the change in accounting estimate in the period that the final settlement amount was determined).

Question 8

In 20X5, in accordance with the entity's newly formulated equity remuneration scheme, the entity issued options to acquire 100 of its own shares to each of its 6,000 employees. This is the only share-based payment transaction into which the entity has ever entered.

In its 31 December 20X5 annual financial statements, Entity A accounted for the equity-settled share-based payment transaction in accordance with Section 26 *Share-based Payment*. Must the entity account for a change in accounting policy in its 20X5 financial statements?

☐ (a) Yes

☐ (b) No

Question 9

Which of the following statements is true?

☐ (a) Financial statements of subsequent periods need not repeat the disclosures required for a change in accounting policy and the correction of a prior period error.

☐ (b) Financial statements of subsequent periods must repeat the disclosures required for a change in accounting policy and the correction of a prior period error.

☐ (c) Financial statements of subsequent periods must repeat the disclosures required for a change in accounting policy and the correction of a prior period error unless it is impracticable to identify the period to which they relate.

Question 10

Which of the following is not a change in accounting policy?

☐ (a) In the current reporting period an entity changed the basis on which it measures a building that is an investment property from the fair value model to the cost model because fair value can no longer be measured reliably without undue cost or effort on an ongoing basis.

☐ (b) An entity measures its only investment property at fair value. In the current reporting period, the entity acquired a second investment property which it measures using the cost model because the fair value of the second investment property cannot be measured reliably without undue cost or effort on an ongoing basis. It continues to account for the first investment property using the fair value model.

☐ (c) In the current reporting period the entity changed the method on which it calculates depreciation of buildings, classified as property, plant and equipment, from the reducing balance method to the straight-line method.

☐ (d) All of (a)–(c) above.

Module 10 – Accounting Policies, Estimates and Errors

Answers

Q1 (c) see definition in the Glossary
Q2 (d) see definition in the Glossary
Q3 (d) see paragraph 10.21
Q4 (c) see paragraph 10.21(a)
Q5 (a) This question is not about the application of Section 10 *Accounting Policies, Estimates and Errors*—the error in the entity's financial statements for the year ended 31 December 20X3 was detected before the financial statements were authorised for issue (ie before the period relevant to the application of the requirements of Section 10). The question is about how to account for an event after the end of the reporting period (see paragraph 32.2 and 32.4).
Q6 (b) see paragraphs 10.15 and 10.16
Q7 (a) see paragraphs 10.19–10.21
Q8 (b) see paragraph 10.9(b)
Q9 (a) see paragraphs 10.13, 10.19 and 10.23
Q10 (d) see paragraphs 10.9(c) and 10.15

Module 10 – Accounting Policies, Estimates and Errors

APPLY YOUR KNOWLEDGE

Apply your knowledge of the requirements for accounting and reporting accounting policies, estimates and errors in accordance with the *IFRS for SMEs* by solving the case studies below.

Once you have completed the case studies check your answers against those set out below this test.

Case study 1

On 1 January 20X1 SME Z paid CU600,000 to acquire a new barge. In the belief that it was entitled to a refund of purchase taxes on the acquisition of the barge, SME Z claimed, and was refunded, CU60,000 by the local government. However, in late 20X7 SME Z repaid the refund when it became apparent that it had made an error in making the claim to the local government as it had not been entitled to the refund of purchase taxes on acquisition of the barge.

From the date of acquisition to 31 December 20X6, SME Z had the following assessments:

- The useful life of the barge is 15 years from the date of acquisition
- The residual value of the barge is nil
- The entity will consume the barge's future economic benefits evenly over 15 years from the date of acquisition.

In 20X7, in the light of the development of new barge preservation treatments, the period over which the barge is expected to be economically usable by one or more users increased from 15 years to 26 years. SME Z now expects to dispose of its barge after using it for 20 years from the date of acquisition (ie a further 14 years). At 31 December 20X7, SME Z assessed the residual value of the barge at CU70,000.

Prepare accounting entries to record the barge in the accounting records of SME Z for the year ended 31 December 20X7.

Answer to case study 1

31 December 20X7

Dr	Cost—property, plant and equipment	CU60,000	
Dr	Cr Cash		CU60,000

To recognise the repayment of the purchase taxes claimed in error.

Dr	Retained earnings at beginning of year	CU24,000[(a)]	
	Cr Accumulated depreciation—PPE		CU24,000

To correct recorded depreciation of the barge from 20X1 to 20X6 for the correction of the purchase taxes claimed in error.

Dr	Profit or loss (depreciation)	CU20,714[(c)]	
	Cr Accumulated depreciation—PPE		CU20,714

To recognize depreciation of the barge for the year ended 31 December 20X7

The calculations and explanatory notes below do not form part of the answer to this case study:

(a) CU4,000[(b)] × 6 years (ie 20X1 to 20X6) = CU24,000.

(b) CU60,000 increase in the cost ÷ 15 years = CU4,000 additional depreciation per year (20X1 to 20X6).

(c) [CU360,000[(d)] less CU70,000 residual value] ÷ 14 years remaining useful life = CU20,714 depreciation for the year ended 31 December 20X7.

(d) CU600,000 cost less (CU40,000[(e)] depreciation × 6 years) accumulated depreciation = CU360,000 corrected carrying amount at 31 December 20X6.

(e) CU600,000 carrying amount ÷ 15 year useful life = CU40,000 corrected depreciation per year (20X1 to 20X6).

Case study 2

In its financial statements for the year ended 31 December 20X1 SME Y reported CU73,500 revenue (sales), CU53,500 cost of goods sold, CU6,000 income tax expense, CU20,000 retained earnings at 1 January 20X1 and CU34,000 retained earnings at 31 December 20X1.

In 20X2, after the 20X1 financial statements were approved for issue, SME Y discovered that some products sold in 20X1 were incorrectly included in inventories at 31 December 20X1 at their cost—CU6,500.

In 20X2, SME Y changed its accounting policy for the measurement of investments in associates after initial recognition from the cost model to the fair value model. It acquired its only investment in an associate for CU3,000 many years ago. The associates equity is not traded on a securities exchange (ie a published price quotation is not available). The fair value of the investment was determined reliably using an appropriate equity valuation model on 31 December 20X2 at CU25,000 (20X1: CU20,000 and 20X0: CU18,000).

At 31 December 20X2, as a result of the invention of improved lubricants, SME Y reassessed the useful life of Machine A from four years to seven years. Machine A is depreciated on the straight-line method to a nil residual value. It was acquired for CU6,000 on 1 January 20X0. Inventories of the type manufactured by Machine A were immaterial at the end of each reporting period.

SME Y's accounting records for the year ended 31 December 20X2, before accounting for the change in accounting policy and before accounting for the change in accounting estimate, record CU104,000 revenue (sales), CU86,500 cost of goods sold (including CU6,500 for the error in opening inventory and CU1,500 depreciation Machine A) and CU5,250 income tax expense. SME Y presents financial statements with one year of comparative information.

For simplicity the tax effect of all items of income and expenses should be assumed to be 30 per cent of the gross amount.

Draft an extract showing how the correction of the prior period error, change in accounting policy and change in accounting estimate could be presented in the statement of income and retained earnings and disclosed in the notes of SME Y for the year ended 31 December 20X2.

Answer to case study 2

Extract from SME Y statement of income and retained earnings for the year ended 31 December 20X2

	Notes	20X2		20X1 Restated	
		CU		CU	
Revenue		104,000		73,500	
Cost of goods sold (20X1 as previously stated CU53,500)		(79,100)	(a)	(60,000)	(d)
Gross profit		24,900		13,500	
Other income—change in the fair value of investment in associate (20X1 as previously stated CU0)		5,000	(b)	2,000	(e)
Profit before tax		29,900		15,500	
Income tax expense (20X1 as previously stated CU6,000)		(8,970)	(c)	(4,650)	(f)
Profit for the year (20X1 as previously stated CU14,000)		20,930		10,850	
Retained earnings—beginning of the year		41,350		30,500	
- as previously stated		34,000		20,000	
- effect of the correction of a prior period error		(4,550)	(g)	-	
- effect of a change in accounting policy		11,900	(m)	10,500	(l)
Retained earnings—end of the year		62,280		41,350	

SME Y

Notes to the financial statements for the year ended 31 December 20X2

Note 9 Profit before tax

Change in accounting estimate

In response to the advent of superior lubricants that prolong the life of the machine used to produce …the estimated useful life of the machine was increased from four years to seven years. The effect of the change in the useful life of the machine is to reduce the depreciation allocation by CU900 in 20X2 and 20X3. The after-tax effect is an increase in profit for the year of CU630 for each of the two years.

Depreciation expense in 20X4-20X6 is increased by CU600 because of the useful life revision, as under the initial estimate, the asset would have been fully depreciated at the end of year 20X3. The after-tax effect for these three years is a decrease in profit for the year of CU420 per year.

Note 11 Correction of prior period error

In 20X2 the entity identified that CU6,500 products that had been sold in 20X1 were in error included in inventory at 31 December 20X1. The financial statements of 20X1 have been restated to correct this error. The effect of the restatement is a CU4,550 decrease in profit for the year ended 31 December 20X1 after decreasing income tax expense by CU1,950. This resulted in a CU4,550 (decrease) restatement of retained earnings at 31 December 20X1.

Note 12 Change in accounting policy

In 20X2 the entity changed its accounting policy for the measurement of investments in associates after initial recognition from the cost model to the fair value model. Management judged that this policy provides reliable and more relevant information because dividend income and changes in fair value are inextricably linked as integral components of the financial performance of an investment in associate and measurement at fair value is necessary if that financial performance is to be reported in a more meaningful way. This change in accounting policy has been accounted for retrospectively. The comparative information has been restated. The effect of the restatement is CU1,400 increase in profit for the year ended 31 December 20X1 including an increase in income tax expense of CU600. This, together with the CU10,500 (increase) restatement of retained earnings at 31 December 20X0, resulted in a CU11,900 increase in retained earnings at 31 December 20X1. Furthermore, profit for the year ended 31 December 20X2 was CU3,500 higher (after deducting CU1,500 tax effect) as a result of recording a further CU5,000[(b)] increase in the fair value of the investment in an associate in 20X2.

The calculations and explanatory notes below do not form part of the answer to this case study:

(a) CU86,500 given less CU6,500 correction of error (now recognised as an expense in 20X1) less CU900[(i)] effect of the change in accounting estimate.

(b) CU25,000 fair value (20X2) less CU20,000 fair value (20X1) = CU5,000 (ie effect of applying the new accounting policy (fair value model) in 20X2).

(c) CU5,250 + CU1,950[(h)] + 30% (CU900(i) reduction in depreciation resulting from the change in accounting estimate) + 30% (CU5,000 increase in the fair value of investment property—change in accounting policy) = CU8,970.

(d) CU53,500 as previously stated + CU6,500 (products sold and incorrectly included in closing inventory in 20X1) = CU60,000 (ie the prior period error is corrected retrospectively by restating the comparatives amounts, in accordance with paragraph 10.20(a)).

(e) CU20,000 fair value (20X1) less CU18,000 fair value (20X0) = CU2,000 (ie effect in 20X1 of the change in accounting policy for investments in associates from the cost model to the fair value model).

(f) CU6,000 as previously stated less CU1,950[(h)] correction of prior period error + 30% (CU2,000 change in accounting policy) = CU4,650.

(g) CU6,500 (products sold and incorrectly included in inventory in 20X1) – CU1,950[(h)] (tax overstated in 20X1) = CU4,550.

(h) CU6,500 (products sold and incorrectly included in inventory in 20X1) × 30% (income tax rate) = CU1,950

(i) CU1,500 depreciation (using old estimate, ie CU6,000 cost ÷ 4 years) less CU600[(j)] using new estimate of useful life = CU900

(j) CU3,000[(k)] carrying amount ÷ 5 years remaining useful life = CU600 depreciation per year

(k) [CU6,000 cost less (CU1,500 depreciation × 2 years)] = CU3,000 carrying amount at 31 December 20X1

(l) (CU 18,000 fair value of investment in associates at 31 December 20X0 less CU3,000 carrying amount based on the cost model at the same date) × (1 less 30% income tax rate) = CU10,500 effect of a change in accounting policy (from cost model to fair value model)

(m) CU10,500[(l)] + [CU2,000[(e)] × (1 less 30% income tax rate)] = CU11,900