Stage 1—Accounting Estimates, Accounting Policies and Errors
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A Framework-based teaching approach to
Accounting for Changes in Accounting Estimates,
Accounting Policies and Errors

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Michael J C Wells, Director, IFRS Education Initiative, IFRS Foundation

This material has benefited greatly from the feedback and comments from people attending a series of workshops on the Framework-based approach to teaching International Financial Reporting Standards (IFRS) organised by the IFRS Foundation and others and from peer review by a number of anonymous reviewers.

Stage 1: teaching material

In this part we present teaching materials on accounting for changes in accounting estimates and policies and the correction of prior period errors that could be used in Stage 1 classes (for example, a first financial reporting course for CA/CPA stream students or students in a business program taking accounting and finance courses). The material includes:

(a) extracts from the IASB’s Conceptual Framework for Financial Reporting (the ‘Conceptual Framework’) and the main principles in IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors and Section 10 Accounting Policies, Estimates and Errors of the IFRS for SMEs;¹

(b) notes for student explanations, examples and discussion questions relating to changes in accounting estimates, accounting policies and errors; and

(c) tutorial questions and suggested answers.

Stage 1: reference material

The following extracts from the Conceptual Framework and Standards (IFRS and the IFRS for SMEs) provide students with the main concepts and principles relevant to accounting estimates and accounting policies; accounting for changes in accounting estimates and accounting policies; and accounting for the correction of prior period errors. The authors envisage that students would have access to copies of these extracts in class and when they are being assessed. This open-book approach is consistent with focusing on developing students’ abilities to apply the requirements of the Standards, instead of having them learn and recite IFRS requirements and mechanically perform repetitive examples. An open-book approach is also more reflective of the ‘real world’ in which accountants must apply the Standards and analysts interpret the resulting financial statements, instead of reciting its requirements. Furthermore, the requirements are likely to change over time and memorising the older versions of such material may not be helpful in the future.

The Conceptual Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors and Section 10 Accounting Policies, Estimates, and Errors of the IFRS for SMEs set out requirements for accounting for changes in accounting estimates and accounting policies, and for the correction of prior period errors.

**Extracts from the Conceptual Framework**

**Objective**

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit (paragraph OB2 of the Conceptual Framework). Other aspects of the Conceptual Framework (for example, a reporting entity concept; the qualitative characteristics of, and the constraint on, useful financial information; elements of financial statements; recognition; measurement; presentation and disclosure) flow logically from the objective (paragraph OB1 of the Conceptual Framework).

Decisions by existing and potential investors about buying, selling or holding equity and debt instruments depend on the returns that they expect from an investment in those instruments; for example, dividends, principal and interest payments or market price increases. Similarly, decisions by existing and potential lenders and other creditors about providing or settling loans and other forms of credit depend on the principal and interest payments or other returns that they expect. **Investors’, lenders’ and other creditors’ expectations about returns depend on their assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity.** Consequently, existing and potential investors, lenders and other creditors need information to help them assess the prospects for future net cash inflows to an entity (paragraph OB3 of the Conceptual Framework).

To assess an entity’s prospects for future net cash inflows, existing and potential investors, lenders and other creditors need information about the resources of the entity, claims against the entity and how efficiently and effectively the entity’s management and governing board have discharged their responsibilities to use the entity’s resources. Examples of such responsibilities include protecting the entity’s resources from unfavourable effects of economic factors, such as price and technological changes, and ensuring that the entity complies with applicable laws, regulations and contractual provisions. Information about management’s discharge of its responsibilities is also useful for decisions by existing investors, lenders and other creditors who have the right to vote on, or otherwise influence, management’s actions (paragraph OB4 of the Conceptual Framework).

**General purpose financial reports**

General purpose financial reports provide information about the financial position of a reporting entity, which is information about the entity’s economic resources and the claims against the reporting entity. Financial reports also provide information about the effects of transactions and other events that change a reporting entity’s economic resources and claims. Both types of information provide useful input for decisions about providing resources to an entity (paragraph OB12 of the Conceptual Framework). Furthermore, information about the
entity’s cash flows also helps users to assess the entity’s ability to generate future net cash inflows (paragraph OB20 of the Conceptual Framework).

**Qualitative characteristics**

*Fundamental qualitative characteristics*—if financial information is to be useful; it must be relevant and faithfully represent what it purports to represent (paragraph QC4 of the Conceptual Framework). Relevant financial information is capable of making a difference in the decisions made by users (see paragraph QC6 of the Conceptual Framework). Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value, or both (paragraph QC7 of the Conceptual Framework). To be a perfectly faithful representation, a depiction would have three characteristics. It would be complete, neutral and free from error (paragraph QC12 of the Conceptual Framework).

*Enhancing qualitative characteristics*—the enhancing qualitative characteristics of useful financial information are comparability, verifiability, timeliness and understandability. These enhance the usefulness of information that is relevant and faithfully represented. The enhancing qualitative characteristics may also help determine the two ways that should be used to depict a phenomenon if both are considered equally relevant and faithfully represented (paragraph QC19 of the Conceptual Framework).

*Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or date* (paragraph QC20 of the Conceptual Framework). *For information to be comparable, like things must look alike and different things must look different* (paragraph QC23 of the Conceptual Framework).

To be useful, information should faithfully represent the economic phenomena it purports to represent. Faithful representation does not mean accurate in all respects. Free from error means that there are no error or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. For example, an estimate of an unobservable price or value cannot be determined to be accurate or inaccurate. However, a representation of that estimate can be faithful if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained and no errors have been made in selecting and applying an appropriate process for developing the estimate (paragraph QC15 of the Conceptual Framework).

In addition, the materiality of information must be considered. Information is material if omitting it or misstating it could influence decisions that users make on the financial information presented by an entity—materiality is an entity-specific aspect of relevance (see paragraph QC11 of the Conceptual Framework).
## Extracts from IAS 8 and Section 10 of the IFRS for SMEs

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<td>Omissions or misstatements of items are <em>material</em> if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omissions or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor. (Paragraph 5 of IAS 8 and paragraph 7 of IAS 1 <em>Presentation of Financial Statements</em>)</td>
<td>Omissions or misstatements of items are <em>material</em> if they could, individually or collectively, influence the economic decisions of users taken 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, could be the determining factor. (Glossary)</td>
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<td>[Accounting] policies need not be applied when the effect of applying them is immaterial. (Paragraph 8 of IAS 8)</td>
<td>[...] the entity need not follow a requirement in this IFRS if the effect of doing so would not be material. (Paragraph 10.3)</td>
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<td>An entity need not provide a specific disclosure required by an IFRS if the information is not material. (Paragraph 31 of IAS 1)</td>
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<td><em>Prior period errors</em> 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. Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud. (Paragraph 5 of IAS 8)</td>
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<td>[...] an entity shall correct material prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery by:</td>
<td>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:</td>
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<td>(a) restating the comparative amounts for the prior period(s) presented in which the error occurred, or</td>
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<td>(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. (Paragraph 42 of IAS 8)</td>
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<td><em>Retrospective restatement</em> is correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred. (Paragraph 5 of IAS 8)</td>
<td>When [...] applied retrospectively [...] to comparative information for prior periods [...] (Paragraph 10.12)</td>
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<td>A prior period error shall be corrected by retrospective restatement except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the error. (Paragraph 42 of IAS 8)</td>
<td>When it is impracticable to determine the period-specific effect of an error on comparative information for one or more periods presented, the entity shall restate the opening balances of assets, liabilities and equity for the earliest period for which retrospective restatement is practicable. (Paragraph 10.22)</td>
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<td><strong>Change in accounting estimate</strong></td>
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<td>A <em>change in accounting estimate</em> 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. (Paragraph 5 of IAS 8)</td>
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<td>future periods, if the change</td>
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<td>affects both. (Paragraph 10.16)</td>
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**Accounting policies**

Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements. (Paragraph 5 of IAS 8)

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

Retrospective application is applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied. (Paragraph 5 of IAS 8)

When a change in accounting policy is applied retrospectively […] the entity shall apply the new accounting policy to comparative information for prior periods […] as if the new accounting policy had always been applied [… ] (Paragraph 10.12)

A change in accounting policy shall be applied retrospectively except to the extent that it is impracticable. (Paragraph 23 of IAS 8)

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 [… ] (Paragraph 10.12)
Stage 1: notes for students

These notes on accounting estimates, accounting policies and errors build on the separate notes provided for Stage 1 students on non-financial assets and liabilities. Those notes introduce students to some of the judgements and estimates in accounting for non-financial assets and liabilities. The notes that follow:

(a) differentiate estimates from other judgements;
(b) briefly revisit the use of judgements, apart from those involving estimates, that management makes in accounting for property, plant and equipment and non-financial liabilities;
(c) briefly revisit the use of accounting estimates in accounting for property, plant and equipment (PPE) and non-financial liabilities;
(d) introduce students to the concept of a prior period error and expand their understanding of accounting policies; and
(e) explore the principles for, and the main judgements in, accounting for:
   (i) changes in accounting estimates;
   (ii) changes in accounting policies; and
   (iii) the correction of prior period errors.

Providing relevant information about an entity’s financial position and its financial performance requires estimates and judgements—to a large extent, financial reports are based on estimates, judgements and models instead of being exact depictions of reality (see paragraph OB11 of the Conceptual Framework). The following section will expand on this, but some judgements involve estimation uncertainty while others do not.

Judgements not involving estimates

An entity must disclose the judgements, apart from those involving estimations, 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 (paragraph 122 of IAS 1 Presentation of Financial Statements).

Revisiting judgements made when applying IAS 37

Judgement—existence of a present obligation: defendant in a lawsuit

In most cases it will be clear whether a past event has given rise to a present obligation. However, in some lawsuits, it may be disputed if certain events have occurred or whether those events result in a present obligation. In such a case, determining whether a present obligation exists at the end of the reporting period requires taking account of all available evidence, which often includes the opinion of experts. The evidence considered includes any additional evidence provided by events after the reporting period. IAS 37 Provisions, Contingent Liabilities and Contingent Assets specifies that a present obligation exists when it is more likely than not (greater than a 50 per cent probability) that an outflow will be required to extinguish the obligation.

See http://www.ifrs.org/Use-around-the-world/Education/Pages/Framework-based-teaching-material.aspx
Judgement—recognition of a present obligation: contravention of the Highway Code

Today you exceeded the speed limit when driving your company’s car to visit a client. A present obligation exists—you know that you have contravened the law and a penalty applies. However, you assess that it is more likely than not that your contravention of the law was not detected. Consequently, in applying IAS 37 you decide not to recognise a liability in respect of the present obligation—it is not probable that you will pay the fine for contravening the speed limit. In other words, it is not probable that resources will flow from your company (the reporting entity) to settle the present obligation.

Revisiting judgement when applying IAS 16

Discussion question—materiality

A large, listed, highly profitable, multinational entity, whose financial statements are presented in millions of CUs, follows an accounting policy of recognising individual items of PPE that cost less than CU100 as an expense on initial recognition.

Does this policy contravene IFRS?

Accounting estimates

The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability (paragraph 4.41 of the Conceptual Framework). These and other issues that require judgement are explored further at Stage 2.

An entity must disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year (paragraph 125 of IAS 1).

Revisiting estimates when applying IAS 37

Estimate—measurement of a lawsuit

Significant uncertainty exists with respect to the measurement (encapsulating the amount, timing and uncertainty of future outflows from the entity to extinguish (by settlement or by transfer)) of a present obligation. For example, measuring the present obligation that is the subject of a lawsuit requires estimating when the court will rule and judging what the possible outcomes of the case may be. It also requires determining a rational and consistent basis on which those uncertainties can be factored into measuring the amount that the defendant would, at the reporting date, rationally pay to extinguish the liability through settlement or transfer. However, it is important to remember that the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability (see paragraph 4.41 of the Conceptual Framework). Consequently, such estimates do not prevent the measurement of an amount reported in the financial statements.

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3 In this education module, monetary amounts are denominated in ‘currency units’ (CU).
Revisiting estimates when applying IAS 16

Measuring the cost of an item of PPE (particularly if it is self-constructed) requires many estimates. The subsequent allocation of depreciation involves further judgements and estimates, including:

(a) allocating the cost of the asset to particular major components;
(b) determining the most appropriate depreciation method;
(c) estimating useful life; and
(d) estimating residual value.

Only if the major components of an item of PPE have significantly different patterns of consumption of economic benefits or different useful lives, or both, does an entity allocate the initial cost of the asset to its major components and depreciate each such component separately over its useful life. For example, it would be appropriate to depreciate separately the airframe and engines of an aircraft when these two components have different useful lives (the airframe’s estimated useful life is 20 years whereas the engines’ estimated useful life is 5,000 flying hours), because depreciating the aircraft as a whole using an approximation technique (such as a weighted average useful life for the item as a whole) would not result in depreciation that faithfully represents the consumption of the service potential for the separate parts. When the carrying amount of PPE is divided into separate components, for calculating depreciation only, each component is treated as though it were a separate asset. That implies that the carrying amount of that component is “written off” (recognised as an expense) when that component is scrapped or sold, with the cost of any replacement being treated as a separate component of the item.

An entity must use a depreciation method that reflects the pattern in which it expects to consume the asset’s future economic benefits. Possible depreciation methods include the straight-line method, the diminishing balance method and a method based on use, such as the units of production method (the method illustrated previously).

‘Useful life’ refers to the period during which the asset is expected to be used by the entity. Consequently, that period can be shorter than (but no longer than) an asset’s total economic life—the period over which an asset is expected to be economically usable by one or more users. For example, if an entity expects to use a photocopier for two years (measured from the date of purchase) but the photocopier could be used by one or more users for five years, then the photocopier’s useful life is two years and its economic life is five years. Where the asset has a useful life that is shorter than its economic life, it is likely to have a substantial residual value, because part of the carrying amount of the asset could (and usually would) be recovered through the sale of the asset to another entity (instead of through use by the entity itself).

The residual value of an item of PPE is calculated in the following way: if the item was at the end of its useful life today, and was in the condition expected at the end of its useful life, what would the entity receive today from selling that item (net of disposal costs)? If there is not an active market for such items of PPE, then judgement is used to estimate an item’s residual value.
Accounting estimates relating to other account balances

As a result of the uncertainties inherent in business, many items in financial statements cannot be measured with precision because of uncertainties in the amount, timing and certainty of future resource flows. However, an entity can generally estimate reliably (ie a depiction that is complete, neutral and free from error) one or more measures of:

(a) the future net cash inflows embodied in a resource that it controls (an asset); or

(b) the future outflows from the entity necessary to extinguish (by settlement or by transfer) a present obligation (a liability).

Such estimation involves judgements based on the latest available, reliable information. For example, estimates may be required to measure:

(a) the impairment of trade receivables (sometimes called ‘bad debts’);

(b) the impairment of inventories (sometimes called ‘inventory obsolescence’); and

(c) the fair value of financial assets or financial liabilities (paragraph 32 of IAS 8).

Framework-based teaching

Step 1: Identifying the economics of the phenomena—students need to consider the economics of the phenomena in which the accounting is used. For instance, once students understand what a prior period error is and they appreciate why material errors create distortions between accounting periods if they are not corrected, they are then ready to develop their understanding of accounting for retrospective application.

Step 2: Identifying the aspects of the phenomena useful to users of financial statements—what information about the phenomena would existing and potential investors, creditors and other lenders find useful in making resource allocation decisions? For instance, what reporting for changes in estimates would best enable primary users to make their own predictions of an entity’s future net resource flows? In general, to apply the fundamental qualitative characteristics of the Conceptual Framework, students need to identify the type of information about the phenomena that would be most relevant. Secondly, students need to determine whether that information is available and can be faithfully represented. If not, the process is repeated with the next most relevant type of information.

Step 3: Introduce the principle that specifies the accounting—teachers can now introduce the principle that specifies the requirements for accounting estimates, accounting policies and errors and the disclosure requirements associated with each one. In instances in which no Standard addresses the economic phenomena, judgement is needed at this stage to develop an accounting policy and judgements and estimates are needed to apply the requirements with rigour and consistency.

Step 4: Evaluating whether the accounting is consistent with the objective of financial reporting—teachers can now ask if the accounting is consistent with the objective of financial reporting and the concepts that flow from that objective. In cases in which the accounting does not maximise the objective of financial reporting, students could be lead to the reasons why. For instance, when a change in an accounting policy or a correction of error is immaterial, the exception to the principle of retrospective application does not derogate from
the objective of financial information. In Stage 2, the requirement of prospective application when revaluing PPE further illustrates an exception to retrospective restatement.

Module format

*Developing accounting estimates*—this section introduces the question: why are estimates essential in financial reporting? Students are taught that the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability (paragraph 33 of IAS 8).

*Determining what is useful information*—this section introduces the question: what information would an existing or potential investor, lender or other creditor need in order to make an investment or lending decision? This question is to focus students’ mindset on the information needs of primary users (i.e., potential and existing investors, lenders and other creditors that cannot require the reporting entity to provide information directly to them) in making decisions about providing resources to the entity (for example, whether to buy, hold or sell shares in the entity, or to fund a loan or to require settlement of a loan).

*Revising accounting estimates*—this section introduces the question: why are estimates revised and what amount should the entity record in the current period? This section aims to develop students’ understanding of why estimates may need revision in the light of additional information discovered in the future. An estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience. By its nature, the revision of an estimate does not relate to prior periods and is not the correction of an error (paragraph 34 of IAS 8).

*Identifying a change in an estimate*—students may confuse a change in an accounting policy with a change in an accounting estimate. A change in the measurement basis applied is a change in an accounting policy, and is not a change in an accounting estimate. 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 (paragraph 35 of IAS 8).

*Assessing materiality*—in practice, preparers must determine materiality on a case-by-case basis because materiality is an entity specific condition and requires judgement. IFRS sets out accounting principles that are designed to result in financial reporting of relevant and reliable information about the transactions, other events and conditions to which they apply. However, those policies need not be applied when the effect of applying them is immaterial.

Note: the examples that follow are relatively straightforward. As students move on to Stage 2, the examples become more complex and the exercise of judgement is necessary. This module begins with developing an accounting estimate (Example 1) before moving forward with identifying a change in an accounting estimate (Examples 2 and 3). Example 4 is an example of a correction of error and Example 5 is an example of a revaluation of investment property.

**Example 1: developing an accounting estimate—inventory obsolescence**

At 31 December 20x1 a toy manufacturer must estimate whether there are any obsolete toys in its inventory. The toy manufacturer bases its production schedules for toy products on customer orders and its forecasts of demand, taking into account historical trends, results of
market research and current market information. The toy manufacturer usually manufactures products to meet delivery schedules specified by its customers, who usually request delivery within three months of placing an order.

In anticipation of increased retail sales in the holiday season, the toy manufacturer increases its production in advance of the peak selling period, resulting in a corresponding build-up of inventory levels. These seasonal purchasing patterns and requisite production lead times cause risk to the toy manufacturer’s business associated with the underproduction of popular toys and the overproduction of toys that do not match consumer demand (possibly linked to insufficient demand creation through advertising and not anticipating new trends in child toy preferences).

After the holiday season, at the end of its annual reporting period, the toy manufacturer estimates that toys it holds with a historical cost of CU700,000 are unsaleable.

What is the uncertainty inherent in estimating unsaleable inventory?

Management must on the basis of its experience and the latest available, reliable evidence (for example, about estimated future demand) judge how many of the toys it holds in inventory it will not sell in the foreseeable future. If the analysis reveals little or no demand for the units remaining in inventory, an impairment of the inventory to nil is required. The amount of any write-down of inventories to net realisable value and all losses of inventories shall be recognised as an expense in the period the write-down occurs. However, if the units are saleable but only at a steeply discounted price, management must estimate the net realisable value of the inventories (ie expected selling price after the discount less expected costs to sell) and recognise an impairment expense to the extent that the cost of the inventories (itself an estimate) exceeds the estimated net realisable value.

Why does this estimate matter to primary users?

Many individual investors, lenders and other creditors cannot require the reporting entity to provide information directly to them in making decisions about providing resources to the entity. General purpose financial statements are prepared for these primary users to make their own assessments of the expected future net cash-generating potential of the entity and the level of risk the entity may face in the future. The sale of inventory is a key cash-generating activity for retailers and manufacturers. The cost (or value) of the resources consumed in manufacturing an item of inventory (asset) must not be reported at an amount that exceeds the future net cash inflows expected from the sale of that inventory, because overstating the future economic benefits embodied in an inventory asset would likely result in primary users being unrealistically optimistic in their projections of future net cash inflows made on the basis of that financial information.

Journal entries

The excess of the cost over the net realisable value is recognised as an expense (called impairment of inventory) in profit or loss for the period in which the impairment occurred. The following journal entries could be used to record a CU700,000 impairment:

Debit   Expense—profit or loss: cost of sales (impairment)  700,000
Credit   Asset—inventory  700,000
Changes in accounting estimates

An estimate may need revision if (paragraph 34 of IAS 8):

(a) changes occur in the circumstances on which the estimate was based; or
(b) as a result of new information or more experience.

By its nature, the revision of an estimate:

(a) does not relate to prior periods; and
(b) is not the correction of an error.

Consequently, changes in accounting estimates are presented prospectively without restating prior comparative periods.

Example 2: change in estimate—impairment of trade receivables

At 31 December 20x0 a publisher has CU200,000 trade receivable from a book retailer. Because the publisher assesses that the retailer is in financial difficulty it stops supplying the retailer with books.

On the basis of all reasonable and supportable information at 31 December 20x0, the publisher estimates that CU50,000 of the CU200,000 due would not be recovered from the retailer. Consequently, the publisher recognised an impairment expense of CU50,000 in profit or loss for 20x0 and the receivable is included in the publisher’s statement of financial position at CU150,000.

In 20x1 the retailer’s financial position deteriorates further and in late 20x1 the retailer enters bankruptcy proceedings.

On the basis of all reasonable and supportable information at 31 December 20x1, the publisher estimates that it will recover only CU10,000 of the trade receivable.

How does uncertainty in the collectability of the trade receivable change over time?

Determining the expected cash inflows from a trade receivable involves estimating future collection patterns after the reporting date. The ability to collect its outstanding receivables is a key cash-generating activity. A faithful representation of the amount not expected to be collected is useful information to primary users. In addition, reporting trade receivables at the expected realisable amount provides relevant information and faithfully represents the future cash inflows from collecting the receivables.

In this case, learning that a major retailer-customer in financial difficulty has entered bankruptcy proceedings has provided better information to the supplier regarding the likely collection amount. Previous estimates need revision in the light of this new information. The new information relates to changes in the circumstances in 20x1 when the customer’s financial position deteriorated further. Consequently, by its nature, the revision of an estimate does not relate to prior periods and is not the correction of an error. The change in estimate relates to the current period forward, and is therefore presented prospectively without restating prior comparative periods.

Journal entries

The publisher could record the change in estimate prospectively by using the following journal entries:
Debit  Expense—profit or loss: bad debt expense  140,000  
Credit  Asset: financial asset: trade receivables  140,000  

Accounting for the change in estimate in the recoverability of the trade receivables when the customer entered bankruptcy proceeding in 20x1.

Calculation:
20x0: CU200,000 – CU50,000 impairment = CU150,000 trade receivable 31 December 20x0
20x1: CU150,000 – CU140,000 impairment = CU10,000 trade receivable 31 December 20x1

Example 3: change in estimate—useful lives of depreciable assets

On 1 January 20x1 a cheese manufacturer modernises its equipment by replacement to enable it to double its output to 2,000 wheels of cheese per production run.

The old machine was depreciated evenly over 10 years with no residual value. The new machine cost CU100 million. Because the new machine is an innovation to the industry, the cheese manufacturer intends to operate it until the end of its useful life. However, its useful life is difficult to estimate because the machine embodies new technology. The entity initially estimates a useful life of 10 years and no residual value.

Two years later (on 1 January 20x3), the cheese manufacturer enters into a long-term contract with an Asian distributor who operates in a market in which cheese consumption is rapidly growing. The cheese manufacturer reassesses the economic life of the new machine from a total of 10 years to 7 years, because the new machine will be operating 8 additional hours each day during the remaining 5 years to fill the increased orders. In addition, the manufacturer decides that it will sell the machines 3 years before reaching the end of their estimated economic life to ensure that production is not interrupted by aged machines. Management estimates that it would currently obtain CU10 million from disposal of the machine, after deducting the estimated costs of disposal, if the new machine was already 2 years older and in the condition expected 2 years later.

Summary of facts

<table>
<thead>
<tr>
<th></th>
<th>Economic life</th>
<th>Useful life</th>
<th>Residual value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original estimate (20x1)</td>
<td>10 years</td>
<td>10 years</td>
<td>nil</td>
</tr>
<tr>
<td>Revised estimate remaining (20x3)</td>
<td>5 years</td>
<td>2 years</td>
<td>CU10 million</td>
</tr>
</tbody>
</table>

Estimating depreciation—the consumption of the machine’s service potential

To estimate the life span (economic life) of an item of PPE, management often looks to its experience in reliably estimating the life of similar items of PPE. However, those estimates must be revised when new information becomes available, the pattern of usage changes or changes to technology necessitate an earlier planned retirement of assets than initially expected. Similarly, estimates of the entity’s expected usage (the useful life) of an item of PPE must be updated. In this example, at 1 January 20x3, although the remaining economic life is five years, the remaining useful life is only 2 years because the manufacturer now (20x3) intends to replace the machine before the end of its economic life to ensure that production is not interrupted by aged machines. The change in the entity’s asset management policy affects the estimate of the useful life of the asset—it is a matter of judgement,
sometimes based on the entity’s experience with similar assets (paragraph 57 of IAS 16 Property, Plant and Equipment). Among other things, an entity’s depreciation policy allows primary users to assess the timing of expected replacement of that productive asset.

The future economic benefits embodied in a depreciable asset are consumed by an entity principally through its use. However, other factors, such as technical or commercial obsolescence and wear and tear while an asset remains idle, often result in the diminution of the economic benefits that might otherwise have been obtained from the asset. Consequently, all the following factors are considered in determining the useful life of an asset:

(a) expected usage of the asset. Usage is assessed by reference to the asset’s expected capacity or physical output.

(b) expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle.

(c) technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset. Expected future reductions in the selling price of an item that was produced using an asset could indicate the expectation of the technical or commercial obsolescence of the asset, which, in turn, may reflect a reduction of the future economic benefits embodied in the asset.

(d) legal or similar limits on the use of the asset, such as the expiry dates of related leases (paragraph 56 of IAS 16).

Changes in accounting estimates—depreciation

All the factors identified in paragraph 56 of IAS 16 may change over time. Consequently, the residual value and useful life of an asset must be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) shall be accounted for as a change in an accounting estimate in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

Depreciation for the current period is calculated and accounted for based on the revised accounting estimates of 2 years for the remaining useful life and a residual value of CU10 million. Consequently, depreciation for the current year (ie the year the estimate was revised) is recorded as follows:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Expense—profit or loss: depreciation expense</th>
<th>35,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit</td>
<td>Asset—PPE: accumulated depreciation</td>
<td>35,000,000</td>
</tr>
</tbody>
</table>

Calculations

Accumulated depreciation (Years 1–2): \[100,000,000 \div 10 \times 2 = 20,000,000\]

Carrying amount beginning of Year 3: \[100,000,000 – 20,000,000\] = 80,000,000

New depreciation amount: \[80,000,000 – 10,000,000\] residual \div 2 years = 35,000,000

Note: the change in estimate is applied prospectively (ie in the current period and in future periods) until another change in estimate relating to the machines revises the yearly depreciation amount.
**Errors**

Errors can arise in respect of the recognition, measurements, presentation or disclosure of elements of financial statements. Financial statements do not comply with IFRS if they contain either:

(a) material errors (errors that could affect a user’s decision made on the basis of the financial information); or

(b) immaterial errors made intentionally to achieve a particular presentation of an entity’s financial position, financial performance or cash flows (paragraph 41 of IAS 8).

Errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts and fraud\(^4\) (paragraph 5 of IAS 8).

Prior period errors are omissions from, and misstatements in, the entity’s financial statements for one or more prior periods arising from failure to apply, 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 (paragraph 5 of IAS 8).

**Correction of prior period errors**

The principle for the correction of a prior period error is to retrospectively restate it (ie prepare the information for any comparative period presented as if the error had not occurred).

To understand the principle, assume you are deciding whether to buy shares in Entity A or Entity B. The companies are identical—they have the same transactions with the same counterparties; they are in the same jurisdiction; they were both formed on 01/01/20x4.

<table>
<thead>
<tr>
<th>Profit for year</th>
<th>20x5</th>
<th>20x4</th>
<th>20x5 + 20x4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entity A</td>
<td>50</td>
<td>50</td>
<td>100</td>
</tr>
<tr>
<td>In error Entity B reports CU40 profit in its 20x4 accounts</td>
<td>?</td>
<td>?</td>
<td>?</td>
</tr>
</tbody>
</table>

Which of the following presentations of **Entity B’s profit** in its 20x5 accounts would best inform your decision to invest in Entity A or Entity B?

<table>
<thead>
<tr>
<th>Alternatives</th>
<th>Explanation</th>
<th>20x5</th>
<th>20x4</th>
<th>20x5 + 20x4</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a)</td>
<td>Restate comparative figures (20x4) to correct error</td>
<td>50</td>
<td>50</td>
<td>100</td>
</tr>
<tr>
<td>(b)</td>
<td>Overstate 20x5 profits—compensating error</td>
<td>60</td>
<td>40</td>
<td>100</td>
</tr>
<tr>
<td>(c)</td>
<td>Ignore the prior period error—leave it uncorrected</td>
<td>50</td>
<td>40</td>
<td>90</td>
</tr>
</tbody>
</table>

\(^4\) Fraud includes intentional errors made with the intent to mislead.

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Only alternative (a) faithfully represents the profits made in 20x5 and 20x4. In other words, only alternative (a) provides a potential investor (a primary user) with information that is useful to its decision—whether to invest in Entity A or Entity B. Alternatives (b) and (c) present Entity B as undergoing considerable growth in earnings in 20x5, which could reasonably lead a potential investor to select Entity B over Entity A.

Example 4: correction of error—revenue recognised in wrong accounting period

At 31 December 20x1 a supplier of books shipped books to satisfy a large order by a new customer in the amount of CU100,000. The supplier recorded the sale in 20x2, instead of 20x1:

(a) the trade receivable and income (revenue) CU100,000; and
(b) cost of sales expense and reduction in the inventory asset of CU60,000.

The error was discovered by an internal audit on 31 December 20x2 and the error was considered material by management.

To account for the error, the supplier would retrospectively restate 20x1 to reflect the sale happening in that year. In addition, the supplier would correct 20x2 by reversing out the erroneous sale and cost of sales and adjust retained earnings for the gross profit that would have been recorded in 20x1 if the error had not occurred.

The correction at 31 December 20x2 is illustrated as follows:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Income—profit or loss for 20x2: revenue</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Credit Expense—profit or loss for 20x2: cost of sales</td>
<td>60,000</td>
<td></td>
</tr>
<tr>
<td>Credit Equity: opening retained earnings (01/01/20x2)</td>
<td>40,000</td>
<td></td>
</tr>
</tbody>
</table>

To reverse revenue and cost of sales recognised in error from 20x2 for a sales transaction that occurred in 20x1 and to increase retained earnings at 1 January 20x2 for the gross profit earned on that sale in 20x1.

Retrospective restatement of comparative information for 20x1 in the entity’s 20x2 financial statements

Profit or loss for 20x1—revenue would be restated (increased) by CU100,000 and cost of sales will be restated (increased) by CU60,000.

Retrospective restatement of the comparative information at 31 December 20x1 in the entity’s 20x2 statement of financial position—trade receivables are restated (increased by CU100,000), inventory is restated (reduced by CU60,000) and retained earnings at 31 December 20x1 are restated (increased by CU40,000).

The following table illustrates the effect on the comparative financial statements after the error is corrected and presented retrospectively.

<table>
<thead>
<tr>
<th>Statement of profit or loss</th>
<th>20x2</th>
<th>20x1 (restated)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>Actual</td>
<td>+100,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>Actual</td>
<td>+60,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>Actual</td>
<td>+40,000</td>
</tr>
</tbody>
</table>
Statement of financial position

<table>
<thead>
<tr>
<th></th>
<th>20x2</th>
<th>20x1 (restated)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>Actual</td>
<td>+100,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>Actual</td>
<td>-60,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>Actual</td>
<td>+40,000</td>
</tr>
</tbody>
</table>

**Materiality**—it is important to note that if this error was judged to be immaterial, no restatement of 20x1 would be required. For example, the correcting entry would be recorded in 20x2 only if it avoids misstating 20x2. However, if an otherwise immaterial error in 20x1 was made intentionally to achieve a particular presentation, then the financial statements do not comply with IFRS and would need to be restated retrospectively (paragraph 41 of IAS 8).

### Accounting policies

Accounting policies are specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements (paragraph 5 of IAS 8). Accounting policies are designed to provide information capable of making a difference in the decisions made by users (ie relevant) that can be faithfully represented—complete, neutral and free from error etc (paragraphs 8 and 10 of IAS 8). Consequently, an entity can voluntarily change an accounting policy only if the change results in the financial statements providing reliable and more relevant information (see paragraph 14 of IAS 8).

#### Accounting for a change in accounting policy

The principle for accounting for a change in an accounting policy is retrospective application of the new accounting policy (ie prepare the information for any comparative period presented as if the entity had always applied the new accounting policy).

### Example 5: voluntary change in an accounting policy—investment property

Company A accounts for all investment property using the cost model. A large parcel of vacant land was acquired 30 years ago for capital appreciation and to lease to farmers for growing crops. Land prices in the surrounding area increase rapidly. To provide more relevant information to the users of its financial statements, in 20x2 Company A changes its accounting policy for investment property from the cost model to the fair value model. Company A continues to use the cost model for its owner-occupied property (classified as property, plant and equipment).

<table>
<thead>
<tr>
<th>Investment</th>
<th>Historical cost</th>
<th>Fair value (appraised by valuer)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>CU100,000</td>
<td>CU1,000,000 31 December 20x2</td>
</tr>
<tr>
<td></td>
<td></td>
<td>CU900,000 31 December 20x1</td>
</tr>
<tr>
<td></td>
<td></td>
<td>CU750,000 31 December 20x0</td>
</tr>
</tbody>
</table>

---

5 **Investment property** is property (land or a building—or part of a building—or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation, or both, rather than for:

(a) use in the production or supply of goods or services or for administrative purposes; or
(b) sale in the ordinary course of business (paragraph 5 of IAS 40 Investment Property).

6 IAS 40 Investment Property requires disclosure of fair value when the cost model is used.
A change from the cost model to the fair value model is a change in the measurement basis and therefore it is a change in an accounting policy, in accordance with IAS 8, and thus requires retrospective restatement of prior years’ comparative information. For this reason, profit or loss for 20x1 will be restated to include a fair value gain of CU150,000 when reported alongside the 20x2 profit or loss statement. Similarly, in the comparative figures in its 20x2 statement of financial position (as at 31 December 20x1), the entity will show the investment property at CU900,000. The retrospective restatement is meaningful when reported alongside the 20x2 carrying amount of the land (CU1,000,000).

In other words, the investment property (land) would be presented as follows:

<table>
<thead>
<tr>
<th>Statement of financial position</th>
<th>20x2</th>
<th>20x1 (restated)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investments—land</td>
<td>1,000,000</td>
<td>900,000</td>
</tr>
<tr>
<td>Equity—retained earnings</td>
<td>900,000</td>
<td>800,000(^7)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Profit or loss</th>
<th>20x2</th>
<th>20x1 (restated)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value gain on investment property</td>
<td>100,000</td>
<td>150,000</td>
</tr>
</tbody>
</table>

The effect of the change in the accounting policy to fair value can also be illustrated with the following journal entry:

Debit Asset—non-financial asset: investment property 900,000
  Credit Equity—retained earnings 31/12/20x1 800,000
  Credit Income—profit or loss 20x2: fair value gain 100,000

The judgement of materiality—paragraph 8 of IAS 8 provides that accounting policies need not be applied when the effect of applying them is immaterial. In this example, the effect on financial reporting is presumed to be material.

Example 6: Circumstance-driven change from the cost model to the fair value model of measuring investment property

Refer to Example 5 above. However, in this example, Company A (an SME) determines in 20x2 that it must change its accounting for investment property from the cost model to the fair value model because developments in the property market in 20x2 enable Company A’s management to determine reliably on an ongoing basis, without undue cost or effort, the fair value of its investment property. Consequently, the IFRS for SMEs now requires use of the fair value model. Before that (20x1 and prior), Company A must use the cost model.

In this example there is no change in accounting policy—before and after the change in circumstance, those investment properties whose fair value can be measured reliably must be accounted for using the fair value model and those that cannot, must be accounted for using the cost model. Company A’s circumstances, not its accounting policy, has changed in the current reporting period.

Company A will apply prospective application because the IFRS for SMEs specifies the

\(^7\) Cumulative fair value gain as at 31 December 20x1: CU900,000 fair value less CU100,000 historical cost.
circumstances in which each model is used. In other words, unlike Company A in Example 5, Company A in Example 6 will continue to apply the cost model to the comparative information in its financial statements of the year in which it changes to measure investment property using the fair value model.

Investment property will be presented as follows:

<table>
<thead>
<tr>
<th>Statement of financial position</th>
<th>20x2</th>
<th>20x1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investments—land</td>
<td>1,000,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Equity—retained earnings</td>
<td>900,000</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Profit or loss</th>
<th>20x2</th>
<th>20x1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value gain on investment property</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Previously measured using the cost model</td>
<td>900,000</td>
<td>–</td>
</tr>
</tbody>
</table>

The effect of the change in the accounting policy to fair value can also be illustrated with the following journal entry:

```
Debit   Asset—non-financial asset: investment property  900,000  
         Credit Income—profit or loss 20x2: fair value gain  900,000
```

**Furthering your knowledge**—the Stage 2 module on accounting estimates, accounting policies and errors will compare the fair value model for investment property with the revaluation model for property, plant and equipment. In the Stage 2 module, students will distinguish the difference in the disclosure requirements regarding revaluations of PPE compared to investment property. IAS 16 *Property, Plant and Equipment* includes specific transitional provisions applying to a change in an accounting policy from the cost model to the revaluation model of accounting for PPE, which deviates from the principle of retrospective application.
Stage 1: Tutorials

Stage 1: Tutorial #1—identifying changes in accounting estimates, errors and changes in accounting policies and the accounting that flows therefrom

<table>
<thead>
<tr>
<th>Required:</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) For each item below, indicate if the scenario is a change of an accounting estimate, correction of an error, change in an accounting policy, or circumstance driven prospective change in accounting.</td>
</tr>
<tr>
<td>(b) For each item below, indicate whether the change or correction is applied retrospectively or prospectively.</td>
</tr>
</tbody>
</table>

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Entity B determines that it must change from the straight-line method of depreciation to the units-of-production method for its manufacturing machinery after reviewing its consumption pattern and concluding that the units of production method more faithfully represents how it consumes the service potential of its machinery.</td>
</tr>
<tr>
<td>2.</td>
<td>An accounting employee forgets to recognise as an expense and a liability for a court case that the entity is defending and that it is more likely than not to lose. The oversight is discovered in the following year after the financial statements are issued.</td>
</tr>
<tr>
<td>3.</td>
<td>Entity Y decides to change its accounting for investment property from the cost model to the fair value model because management concludes that fair value provides more relevant information to the primary users of the entity’s financial statements. IAS 40 Investment Property allows both accounting models.</td>
</tr>
<tr>
<td>4.</td>
<td>Entity Z (an SME) determines that it must change its accounting for its only investment property from the cost model to the fair value model, because recent developments in the property market now enable Entity Z’s management to determine reliably, without undue cost or effort, the fair value of its investment property. The IFRS for SMEs requires use of the fair value model when an entity can determine reliably the fair value of investment property without undue cost or effort, failing which an entity must use the cost model.</td>
</tr>
<tr>
<td>5.</td>
<td>A patent was originally amortised over its estimated useful life of 10 years. After two years, new information indicates that the total useful life will now be only 6 years.</td>
</tr>
<tr>
<td>6.</td>
<td>The residual value of equipment was changed to a higher amount because new market-based evidence demonstrates that the value of this particular type of equipment has increased.</td>
</tr>
<tr>
<td>7.</td>
<td>A provision for removing toxic waste from a property owned by Entity G was measured at CU5 million two years ago. In the third year, new advances in technology reduced substantially the estimate of the expenditure required to extinguish the liability. The best estimate of that provision is now only CU1 million.</td>
</tr>
<tr>
<td>8.</td>
<td>An agricultural company changed its accounting for bearer plants (grapevines and date palm trees) from the fair value less cost to sell model to the cost model, in accordance with an amendment to IAS 41 Agriculture.</td>
</tr>
</tbody>
</table>
9. During 20x2, Beta Co discovered that some products that were sold during 20x1 were incorrectly included in inventory at 31 December 20x1 at CU6,500. The amount is material.
Suggested solution to Tutorial #1—identifying changes in accounting estimates, errors and changes in accounting policies and the accounting that flows from them

1. Change from the straight-line method of depreciation to the units-of-production method:
   (a) a change in an accounting estimate: in accordance with paragraph 61 of IAS 16 Entity B reviews the depreciation method it applies to its machines at least at each financial year-end. Because there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, Entity B changes from the straight-line method to the units-of-production method to reflect the changed pattern. That change in the amount of the periodic consumption of an asset is a change in an accounting estimate resulting from new information or new developments and, accordingly, it is not the correction of an error (paragraph 5 of IAS 8).
   (b) the change in an accounting estimate is applied prospectively by recognising the effect of the change in the accounting estimate in the current and future periods affected by the change (paragraph 61 of IAS 16 and paragraph 5 of IAS 8).

2. Accidental omission of an expense:
   (a) prior period error: omitting the liability for the prior period financial statements when reliable information indicated that it should have been included is an error (see paragraph 5 of IAS 8).
   (b) retrospective restatement: prior period errors are corrected retrospectively. In other words, the financial statements of subsequent periods are prepared as if the error had never occurred, by restating the comparative information.

3. Choosing to change from the cost model to the fair value model of measuring investment property:
   (a) Entity Y’s change from the cost model to the fair value model of accounting for investment property is a voluntary change in accounting policy—IAS 40 permits the use of either model by way of an accounting policy choice. In accordance with paragraph 14 of IAS 8, Entity Y can make the change to the fair value model because it has determined that doing so results in its financial statements providing reliable and more relevant information about investment property.
   (b) retrospective application: in accordance with IAS 8 the new accounting policy (fair value model) must be applied retrospectively. In other words, the financial statements must be prepared as if Entity Y had always applied the fair value model.

4. Circumstance-driven change from the cost model to the fair value model of measuring investment property:
   (a) circumstance-driven prospective change in accounting: before and after the change the entity’s accounting policy is to use the fair value model when it can determine reliably the fair value of the investment property without undue cost
or effort and, when it cannot do so, it uses the cost model instead. Consequently, its circumstance, not its accounting policy, has changed in the current reporting period.

(b) prospective application: because the IFRS for SMEs specifies the circumstances in which each model must be used, Entity Z’s change is not a change of accounting policy and must be applied prospectively. In other words, unlike Entity Y (see Scenario 3), Entity Z will continue to apply the cost model to the comparative information in its financial statements of the year in which it changes to measure investment property using the fair value model.

5. **Change in the estimated useful life of a patent:**

(a) a change in an accounting estimate: in accordance with paragraph 104 of IAS 38 *Intangible Assets*, an entity reviews the useful life it applies to its patent at least at each financial year-end. The change in the useful life of the patent is a change in an accounting estimate resulting from new information or new developments and, accordingly, it is not the correction of an error (see paragraph 5 of IAS 8).

(b) prospective application: because there has been a significant change in the useful life of the patent (from 10 years to 6 years), the entity amortises the patent over its remaining 4-year useful life (the change occurred after two years of use).

6. **Change in residual value:**

(a) change in estimate: in accordance with paragraph 51 of IAS 16 an entity reviews the residual value of its machines at least at each financial year-end. There has been a significant change in an accounting estimate (the residual value of a depreciable asset) resulting from new information or new developments (see paragraph 5 of IAS 8).

(b) prospective application: because there has been a significant change in an accounting estimate (the residual value of a depreciable asset), the updated estimate of residual value is used in the calculation of depreciation in the current year and future years (see paragraph 5 of IAS 8).

7. **Updating the measurement of a provision:**

(a) change in estimate: in accordance with paragraph 59 of IAS 37 an entity reviews the best estimate of its provisions (liabilities of uncertain timing or amount) at each financial year-end. There has been a significant change in an accounting estimate (the best estimate of the provision) resulting from new information or new developments—a change in accounting estimate (see paragraph 5 of IAS 8).

(b) prospective application: because there has been a significant change in an accounting estimate (the best estimate of the provision) resulting from new information or new developments, the accounting estimate is updated prospectively in the current reporting period (see paragraph 5 of IAS 8).
8. Mandatory change from the fair value model to the cost model:
   (a) the entity changes from the fair value model to the cost model of accounting for bearer plants and thus it is a change in accounting policy mandated by a change in IAS 41 (see paragraph 14(a) of IAS 8).
   (b) retrospective application: in accordance with IAS 8 the new accounting policy (cost model) must be applied retrospectively. In other words, the financial statements must be prepared as if the entity had always applied the cost model.

9. Accidental overstatement of inventories asset (if material):
   (a) prior period error: including sold items in inventory is an error in the prior period financial statements (see paragraph 5 of IAS 8).
   (b) retrospective restatement: prior period errors are corrected retrospectively—the financial statements of subsequent periods are prepared as if the error had never occurred by restating the comparative information.
Stage 1: Tutorial #2—change from the fair value model to the cost model

A winery purchased a parcel of vacant land on 1 January 20x0 for CU100 million. Initially it held the land to earn rental income and for capital appreciation.

On 1 January 20x3 the winery occupies the land for the first time and the winery plans to plant vines on it. An appraiser valued the land at CU250 million at 31 December 20x2, CU230 million at 31 December 20x1 and CU200 million at 31 December 20x0.

The winery accounts for investment property using the fair value model and for property, plant and equipment using the cost model.

<table>
<thead>
<tr>
<th>Required:</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Is the change from the fair value model to the cost model for the land a change of accounting policy?</td>
</tr>
<tr>
<td>(b) What is the accounting entry to record the change from the fair value model to the cost model on 1 January 20x3?</td>
</tr>
</tbody>
</table>
Suggested solution to Tutorial #2—change from the fair value model to the cost model

(a) **Is the change from the fair value model to the cost model for the land a change of accounting policy?**

No, the change from the fair value model to the cost model of accounting for the land is not a change in accounting policy. Before and after the change in classification, the entity’s accounting policy for:

(a) investment property is the fair value model; and
(b) property plant and equipment is the cost model.

Consequently, there is no change in accounting policy. What has changed is the purpose to which the entity puts the property. Initially, the property was held to earn lease rentals and for capital appreciation. Now it is the entity’s vineyard—planted with the entity’s grapevines.

This change in use has caused the change in measurement from the fair value model for investment property to the cost model for property, plant and equipment. Consequently, to faithfully represent the underlying economics, the entity must account for the land as investment property from 20x0 through 20x2 and as PPE with effect from the change in use on 1 January 20x3.

(b) **What is the accounting entry to record the change in classification on 1 January 20x3?**

Debit Asset—property, plant and equipment: land 250,000,000

Credit Asset—investment property: land 250,000,000
Stage 1: Tutorial #3—a change in an accounting estimate

Background information

Baking Company bakes bread in batches of 1,000 loaves. To minimise the effect of downtime resulting from cleaning and sterilising the baking machine after each batch, Baking Company decides to modernise its equipment so as to enable it to produce 2,000 loaves per batch—a considerable expected cost savings over the life of the new machines is expected in comparison to the capital outlay required in purchasing the new machine. The old machine was being depreciated over a 10-year useful life with no residual value.

New machine

The new baking machine, costing CU10 million, is an innovation to the industry and therefore Baking Company intends to operate it until the end of its useful life. However, there is much uncertainty about the new machine’s useful life, because it embodies new technology not used before by the industry. The entity initially estimates a useful life of the machine at 10 years with no residual value, after which the machine is estimated to be replaced because of innovations expected to be embodied in baking machines beginning at that time.

After three years, Baking Company overhauls the machine and reassesses the economic life from a total of 10 years to 15 years in the light of its experience with operating and maintaining the machine and the overhaul. In addition, Baking Company estimates that it will sell the machine 2 years before reaching the end of its estimated economic life to ensure that production is not interrupted by the aged machine. Management estimates that it would currently obtain CU10,000 from disposal of the machine, after deducting estimated costs of disposal, if the new machine was already 10 years old and in the condition expected 10 years from now.

Required:

(a) What is the uncertainty inherent in business activities relating to the subsequent accounting treatment of the new machine?

(b) Why is judgement essential to the reporting of the new machine?

(c) You are thinking about buying some shares in Baking Company. What information about the new machine would you want in order to help you to make your investment decision?

(d) Why are estimates revised periodically and what amount for depreciation should the entity report in the current period? Give the journal entry needed.

(e) What amount for depreciation of the new machine should the entity report in the current period (the fourth year of operating the new machine)? Give the journal entry needed.
Suggested solutions to Tutorial #3—a change in an accounting estimate

(a) What is the uncertainty inherent in business activities relating to the subsequent accounting treatment of the new machine?

As a result of the uncertainties inherent in estimating the life span of a long-term productive asset used in operations, management must often rely on previous estimates used with similar equipment. In addition, past experience often forms the most reliable information initially, but those estimates must be revised when new information becomes known, the pattern of usage changes or changes to technology mandate an earlier planned retirement than initially expected.

(b) Why is judgement essential to the reporting of the new machine?

The use of judgement is essential in determining the expected inter-period consumption of the machine’s service potential through its use. Estimates are inherent in financial reporting and most elements in the financial statements (other than cash) are derived in some manner through the use of estimates. Such estimates do not undermine the reliability of the information.

To reflect as depreciation expense the consumption of the machine’s service potential through its use in the period, management must use its judgement to:

(a) estimate the machine’s useful life—defined in terms of the asset’s expected utility to the entity—of the machine. For example, the asset management policy of the entity may involve the disposal of assets after a specified time or after consumption of a specified proportion of the future economic benefits embodied in the asset. (For instance, in this example, although the economic life remaining is 12 years, the useful life remaining is only 10 years because the manufacturer wants to ensure that production is not interrupted by the aged machine.) Consequently, the useful life of the machine is shorter than its economic life. The estimation of the useful life of the asset is a matter of judgement based on the experience of the entity with similar assets (paragraph 57 of IAS 16).

(b) estimate the machine’s residual value—defined in terms of the machine’s estimated value today if the machine was already 10 years old and in the condition expected 10 years from now. Management review this estimate each year.

(c) determine the depreciation method that most closely reflects the pattern in which the entity consumes the new machine’s service potential. The depreciation method is defined in terms of the entity’s expected future consumption of the asset’s service potential. Consequently, depreciation expense for the current period should reflect the consumption of the machine’s service potential in that period through using it to bake bread. Straight-line depreciation is most appropriate when the asset’s service potential depletes evenly over time irrespective of the extent to which the asset is used. In the fact pattern given, the number of loaves that could be baked is unlimited within the 10-year useful life. Consequently, straight-line depreciation is most appropriate because the asset’s service potential depletes evenly over time before the machine is replaced for technological reasons. On the other hand,
the units of production method best reflects the consumption pattern of the machine’s service potential when the service potential of the machine declines in proportion to the output that the machine is used to produce (for example, if the machine must be decommissioned after baking 1 million loaves of bread and the entity expects that the machine will be used by it and possibly others to bake 1 million loaves, then depreciation each period is a proportion of the 1 million loaves based on the actual loaves produced in each period). Consequently, determining the depreciation method is a matter of judgement based on the expected consumption pattern of the asset during its expected useful life in the light of all relevant facts and circumstances at the time of making the judgement.

(d) determine whether there are any significant components of the machine whose pattern of consumption by the entity is so different from the other components of the machine that the component must be depreciated separately.

(c) **What information about the new machine would you want in order to help you to make your investment decision?**

Potential investors likely assess the expected future net cash-generating potential of the entity and the level of risk the entity may face in the future (for example, the expected variability in possible future cash flows). Depreciation assists in assessing the extent to which the machine is consumed through use in the current period and the expected timing of the replacement of the machine.

(a) The depreciation method adopted provides a potential investor with the expected pattern of consumption of service potential, and the service potential remaining with the asset at the end of the reporting period.

(b) The amount reported for accumulated depreciation and depreciation expense provides a potential investor the ability to calculate an estimate of the average remaining period of expected use by the entity or the amount of production the entity expects from using the machines. As the average age approaches the useful life, a potential investor can expect a near-immediate resource outflow (or borrowing) for their replacement.

(c) The residual value of an asset provides a potential investor with an estimate representing the current value of the expected net cash inflows when that asset reaches the end of its useful life.

Factors such as technical or commercial obsolescence and wear and tear while an asset remains idle often also result in the diminution of the economic benefits that may have been obtained from the asset. Consequently, all the following factors are considered in estimating the useful life of an asset:

(a) expected usage of the asset. Usage is assessed by reference to the asset’s expected capacity or physical output.

(b) expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle.

(c) technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or
service output of the asset. Expected future reductions in the selling price of an item that was produced using an asset could indicate the expectation of technical or commercial obsolescence of the asset, which, in turn, may reflect a reduction of the future economic benefits embodied in the asset.

(d) legal or similar limits on the use of the asset, such as the expiry dates of related leases (paragraph 56 of IAS 16).

(d) Why are estimates revised periodically and what amount for depreciation should the entity report in the current period? Give the journal entry needed.

All the factors identified in paragraph 56 of IAS 16 may change over time. In addition, the residual value and useful life of an asset shall be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) shall be accounted for as a change in an accounting estimate in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

Based on revised estimates of the 10 years remaining and a residual value now of CU10,000, a new depreciation amount for the current year is calculated and applied prospectively. The entity will report depreciation expense for the current year in the amount of CU699,000.

The following journal entry illustrates depreciation in the current year:

Debit   Expense—profit or loss: depreciation expense        699,000
Credit  Asset—PPE: accumulated depreciation               699,000

Calculations:
Accumulated depreciation (Years 1–3): \[10,000,000 \div 10 \text{ years}] \times 3 = 3,000,000
Carrying amount at the beginning of Year 4: \[10,000,000 - 3,000,000] = 7,000,000
New depreciation amount: \[7,000,000 - 10,000 \text{ residual}] \div 10 \text{ years} = 699,000
Stage 1: Tutorial #4—correction of an error

At 30 June 20x1 Company XYZ purchases and places in service specialised equipment in order to increase the production capacity in its plant.

Information about the new machine:
(a) cost = CU500,000;
(b) estimated residual value = CU10,000;
(c) estimated useful life = 10 years; and
(d) management judges that the machine’s service potential is consumed through use evenly over time.

On 30 June 20x1, in exchange for the machine, Company XYZ promises to pay the supplier:
(a) interest of CU50,000 on each of 30 June 20x2, 20x3 and 20x4; and
(b) repayment of capital of CU500,000 on 31 December 20x4.

Company XYZ failed to record the new machine and the related promises to pay in its 31 December 20x1 annual financial statements.

The material omission was discovered on 1 November 20x2.

Required:
(a) What information about the omission in the 20x1 financial statements would you want to see in the 20x2 financial statements if, in early 20x3, you were deciding whether to buy Company XYZ shares?
(b) Give the resulting accounting (journal) entry in Company XYZ’s accounting records arising from the discovery of the omission.
(c) How, in accordance with IFRS, would the effect of this change be presented in Company XYZ’s 20x2 financial statements?
Solutions to Tutorial #4—correction of an error

(a) What information about the omission in the 20x1 financial statements would you want to see in the 20x2 financial statements if, in early 20x3, you were deciding whether to buy Company XYZ shares?

To assist me in making my own estimates of Company XYZ’s future cash flows, it would be most useful to prepare the 20x2 financial statements with the comparative information restated for the correction of the prior period error. Understating depreciation expense and interest expense would not be useful information, because it would not faithfully represent the financial performance of the reporting entity and would distort the trend in earnings over time.

Consequently, to correct the error, Company XYZ would retrospective restate the 20x1 statement of financial position to reflect the purchase of the equipment and the related liability incurred.

(b) Give the resulting accounting (journal) entry in Company XYZ’s accounting records arising from the discovery of the omission.

The correction recorded in 20x2 is illustrated as follows:

Debit    Asset—PPE: equipment 500,000
Debit    Equity—retained earnings at 31 December 20x1 49,500
Credit   Asset—PPE: accumulated depreciation 24,500
Credit   Liability—interest payable 25,000
Credit   Liability—payable 500,000

To record the equipment and note at purchase price and reduce retained earnings for interest and depreciation expense for the relevant 6 month period of 20x1 (1 July–31 December 20x1).

Calculations:

Depreciation Expense: [500,000 – 10,000] ÷ 10 years × ½ year = 24,500
Interest Expense: [500,000 × 10%] × ½ year = 25,000
Retained Earnings: [24,500 + 25,000] = 49,500

(c) How, in accordance with IFRS, would the effect of this change be presented in Company XYZ’s 20x2 financial statements?

<table>
<thead>
<tr>
<th>Retrospective presentation creating comparative financial statements</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>20x1 (comparative) profit or loss</strong>—depreciation expense and interest expense would be restated (increased) CU24,500 and CU25,000 respectively, resulting in a reduction to earnings of CU49,500 reflected in profit or loss for 20x1.</td>
</tr>
<tr>
<td><strong>31 December 20x1 (comparative) statement of financial position</strong>—Property, Plant and Equipment (asset) and payable (liability) will both be restated (increased) by CU500,000 to reflect the control of the machines and the existence of the obligation under the financing arrangement at the end of 20x1. Accumulated depreciation will be restated (increased) by CU24,500 to reflect the accumulated consumption of the...</td>
</tr>
</tbody>
</table>
equipment’s service potential in 20x1. Interest payable (liability) will be restated (increased) by CU25,000 representing 6 months of interest cost. Retained earnings at 31 December 20x1 will be restated (decreased) by CU49,500 for the reduction in profit or loss as a result of recognising the depreciation and interest expense.

20x2 profit or loss—a full year of depreciation expense CU49,000 and interest expense CU50,000 will be reported in the normal course of accounting for the asset and liability according to the accounting policies of Company XYZ. The fact pattern assumes no errors in 20x2.

20x2 statement of financial position—the fact pattern assumes no errors in 20x2. The carrying amount of the equipment and the interest payable will be correct after the 20x2 entries are posted to the accounts.

The following table illustrates the effect on the comparative financial statements after the error is corrected and presented retrospectively.

<table>
<thead>
<tr>
<th>Statement of profit or loss</th>
<th>20x1 (restated)</th>
<th>20x2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation expense</td>
<td>+24,500</td>
<td>Actual</td>
</tr>
<tr>
<td>Interest expense</td>
<td>+25,000</td>
<td>Actual</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Statement of financial position</th>
<th>20x1 (restated)</th>
<th>20x2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
<td>+500,000</td>
<td>Actual</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>+24,500</td>
<td>Actual</td>
</tr>
<tr>
<td>Interest payable</td>
<td>+25,000</td>
<td>Actual</td>
</tr>
<tr>
<td>Loan payable</td>
<td>+500,000</td>
<td>Actual</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>-49,500</td>
<td>Actual</td>
</tr>
</tbody>
</table>

Materiality—it is important to note that if this error was judged to be immaterial (ie it could not affect a user’s decision) no restatement of 20x1 would be required. However, if an otherwise immaterial error in prior period financial statements was made intentionally to achieve a particular presentation, then the financial statements do not comply with IFRS and would need to be restated retrospectively (paragraph 41 of IAS 8).