Accounting Changes and Error Corrections

4 CPE Hours

IMPORTANT NOTE: In order to search this doucment, you can use the CTRL+F to locate key terms. You just need to hold down the control key and tap f on your keyboard. When the dialogue box appears, type the term that you want to find and tap your Enter key.

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CONTINUING EDUCATION
for Certified Public Accountants

ACCOUNTING CHANGES AND ERROR CORRECTIONS

Course Overview

This course provides a comprehensive overview of the accounting requirements with respect to accounting changes and error corrections and the related reporting implications within an entity's financial statements. The scope of accounting changes includes a discussion of changes in accounting principles, changes in accounting estimates, as well as changes of a reporting entity. The course also provides an overview of the accounting requirements of correcting errors in previously issued financial statements as well as restatement considerations. A majority of the information included within this course is sourced from the requirements found within FASB ASC Topic No 250, Accounting Changes and Error Corrections.

Learning Objectives

Upon completion of this course, you will be able to:

- ❑ Upon completion of this course, you will be able to:
- ❑ List the different types of accounting changes and how they affect an entity's financial statements
- ❑ Differentiate between the requirements for the different types of accounting changes
- ❑ Identify the steps involved in the required assessment for a correction of an error
- ❑ Differentiate between the iron curtain and rollover methods for quantifying a correction of an error
- ❑ Recognize the different types of restatements required as a result of accounting changes

Field of Study	Accounting
Level of Knowledge	Overview
Prerequisite:	General understanding of FASB ASC Topic No 250
Advanced Preparation	None
Recommended CPE hours	2
Course Qualification	Qualifies for National Registry of CPE Sponsors QAS Self-Study credit
CPE Sponsor Information	NASBA Registry Sponsor #: 138298
Publication Date	September 15, 2018
Expiration Date	September 15, 2019
Deadline to Complete the Course	One year from the date of purchase to complete the examination and submit it to our office for grading

Contact customer service within five business days of your course purchase date for assistance with returns and cancellations. Customers who cancel orders within five business days of the course purchase date will receive a full refund. After five business days all sales are final and no refunds will be provided.

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Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that follow at the end of course. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

Introduction

The accounting principles related to accounting changes and error corrections, as noted in the course overview above, are included within ASC Topic No. 250. Similar to many other ASC topics, this topic includes a discussion of the objectives of the guidance, scope exceptions, a glossary, as well as presentation and disclosure matters. When you refer to the status section of this ASC topic (ASC 250-10-00), you will quickly note that the amendments included within this subtopic through the issuance of FASB Accounting Standards Updates (ASUs) are fairly limited, at least relative to other ASC topics which have been extensively revised over the years. For example, if you were to review the status section of ASC 815, *Derivatives and Hedging*, you will note that it has been extensively updated through multiple ASUs to include, but not limited to, ASU 2016-01, ASU 2015-13, ASU 2014-03, ASU 2013-01, etc. On quick pass, it's apparent that this particular ASC topic has been revised nearly every year by the FASB, whereas ASC 250, not so much. The guidance within ASC 250 has only been amended by a handful of ASUs over the last few years, the majority of the amendments being technical corrections and other confirming amendments brought about by ASUs that have more significantly affected other ASC topics. A more comprehensive discussion of these ASUs will be discussed in more detail in the final section of this course.

As noted in the overview above, this course focuses on accounting changes and error corrections. Specific to accounting changes, this can take the shape of any of the following:

- Changes in accounting principle;
- Changes in accounting estimates;
- Changes in reporting entity;

In addition, error corrections are also discussed at length. It's important to note that an error correction is not an accounting change and is separate and apart from the situations discussed above. Instead, an error correction involves adjustments to previously issued financial statements similar to those generally applicable to reporting an accounting change retrospectively (ASC 250-10-05-4). Each of the three types of accounting changes notes above, along with the accounting and reporting requirements with respect to error corrections is the primary focus of this course.

Changes in Accounting Principle

The first topic we address in this course is the accounting and reporting requirements with respect to changes in accounting principle. Before that, let's first identify what is meant by a change in accounting principle. Simply put, a change in accounting principle is a situation where an entity changes from reporting from one generally acceptable accounting principle (GAAP) to another. In other words, one permitted principle to another permitted principle. For example, this could be a situation where an entity changes its inventory method from First-In First-Out (FIFO) to Last-In First-Out (LIFO). Give that both of these types of inventory methods are accepted accounting principles, this change is considered a change in accounting principle. However, if the entity switched to the FIFO method (a GAAP method) from a previous method that was not in compliance with GAAP, this would not be considered a change in accounting principle, but would instead be a correction of an error (discussed later). This distinction is important to keep in mind as we process through the course. Refer to Exhibit 1-1 below which summarizes some of the general requirements with respect to application of accounting principles.

Exhibit 1-1: ASC 250-10-45-1

A presumption exists that an accounting principle once adopted shall not be changed in accounting for events and transactions of a similar type. Consistent use of the same accounting principle from one accounting period to another enhances the utility of financial statements for users by facilitating analysis and understanding of comparative accounting data.

The ASC statement above also further prescribes that neither of the following would be considered a change in accounting principle:

- Initial adoption of an accounting principle in recognition of events or transactions occurring for the first time or that previously were immaterial in their effect;
- Adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring;

Since it is apparent based on the guidance above that the initial adoption of an accounting principle is not considered a change, nor is an adoption or modification of an accounting principle based on changes in transaction or events, the next obvious question is what is considered a change in accounting principle? To answer this question, the FASB provides specific guidance on exactly what is considered a change in accounting principle. This includes each of the following (ASC 250-10-45-2):

- The change is required by a newly issued Codification update (for example, an ASU);
- The entity can justify the use of an allowable alternative accounting principle on the basis that it is preferable;

The first bullet point above is pretty straight forward and speaks for itself. This relates to new ASUs that are issued by the FASB from time to time, and as we saw, can affect various ASC topics more than others. The application of the amendments in these ASUs are not voluntary, but instead, would be required by all entities who are in scope of the changes and the ASC for which the ASU is amending.

The second bullet relates to more voluntary changes, but one in which an entity can justify the use of an allowable alternative on the basis of preferability. For example, this could be case where an entity does any of the following:

- Changes its method of amortizing actuarial gains and losses of retirement benefits;
- Changes its inventory valuation method (i.e., from LIFO to FIFO, retail inventory method to weighted average cost, etc.);
- Changes its measurement date for conducting its annual goodwill impairment test;

The key point related to these voluntary changes in accounting principles noted above is that the entity must be able to justify that the change is preferable. Said another way, the entity cannot freely change back and forth between accounting principles if one results in a more favorable treatment. An entity should select the appropriate accounting principle based on the facts and circumstances of the transactions (assuming there are different options for accounting for this certain transaction) and the entity should apply that selected principle consistently.

Accounting for the Change in Accounting Principle

ASC 250 requires that an entity report a change in accounting principle through retrospective application of the new accounting principle to all prior periods, unless it is impracticable to do so (ASC 250-10-45-5). There are two key points that are important to address further including 1) what is meant by retrospective application and 2) how does an entity justify whether it is impractical to do so.

The answer to the first question is that retrospective application of a change in accounting principle requires the following:

- The cumulative effect of the change to the new accounting principle on periods prior to those presented is reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented;
- An offsetting adjustment, if any, is made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period;
- Financial statements for each individual prior period presented are adjusted to reflect the period specific effects of applying the new accounting principle;

It is also important to note the distinction between retrospective application and restatement. Restatement is more likely the case with a material error correction. This distinction noted within the ASC Master Glossary when these two terms are defined is intended to reflect the conclusion that it preferable to use the same terms as International Financial Reporting Standards (IFRS) whenever possible to reduce the potential for inconsistent application of accounting principles. Additionally, the terminology change better distinguishes changes in amounts reported for prior periods related to a voluntary change in accounting principle from those changes related to the correction of an error. The distinction in terminology also helps to eliminate the negative connotation associated with all changes to prior period financial statements, and instead uses the term restatement for changes required by the correction of an error. Think about when you hear the term restatement of an entity's earnings. This is generally associated with an error.

The use of the retrospective application approach results in greater consistency of financial information reported across periods because it reflects the financial statements as if a newly adopted accounting principle had always been used historically. In other words, somewhat of a proforma view. Furthermore, regarding recognizing the cumulative effect of a change in accounting principle in opening retained earnings, the FASB concluded that it would be inappropriate to record the cumulative effects on prior periods in net income of the period of change because none of the effects relate directly to that period. Accordingly, while new ASUs may, under certain circumstances, require recognizing a cumulative effect as of a specific date as the transition method, that cumulative effect will be recognized in retained earnings as opposed to net income in the period of the change. This is another important point to keep in mind.

ASC 250 also requires that retrospective application only include the direct effects of a change in accounting principle. An example of a direct effect would include any related income tax effects in prior period financial statements on account of the change in accounting principle. However, if as a result of retrospective application, indirect effects of a change in accounting principle resulted, these indirect effects should be recognized in the period in which the accounting change is made (not retrospectively applied). Said another way, any indirect effects should be recognized in the period of the accounting change and not in the prior period that is affected by the retrospective application.

ASC 250 does, however, provide an impracticability exception to the retrospective application requirement that may result in limited, or in some cases, no retrospective application of the accounting change to prior periods. More specifically, there are two situations identified in ASC 250-10-45-6 and 45-7 that affect an entity's ability to retrospectively apply a change in accounting principle. Refer to Exhibit 1-2 for an overview of these two situations.

Exhibit 1-2: Impracticability Exceptions

Exception 1

The cumulative effect of applying a change in accounting principle to all prior periods can be determined, but it is impracticable to determine the period-specific effects of that change on all prior periods presented;

Exception 2

It is impracticable to determine the cumulative effect of applying a change in accounting principle to any prior period.

As you likely guessed, there are very specific requirements that an entity must meet before concluding that it is impractical to reflect a change in accounting principle on a retrospective basis. In other words, an entity cannot loosely assert that it is too difficult to apply the effects of a change in accounting principle to prior periods because it does not want to go through the hassle. If an entity wishes to assert this position, it should be able to support that it meets the following requirements (ASC 250-10-45-9):

- After making every reasonable effort to do so, the entity is unable to apply the requirement;
- Retrospective application requires assumptions about management's intent in a prior period that cannot be independently substantiated;
- Retrospective application requires significant estimates of amounts, and it is impossible to distinguish objectively information about those estimates that both:
    - Provides evidence of circumstances that existed on the date(s) at which those amounts would be recognized, measured, or disclosed under retrospective application, and
    - Would have been available when the financial statements for that prior period were issued.

One of the key conditions noted above relates to the interpretation of what constitutes an entity "making every reasonable effort…" This will require judgment on the part of management and the independent auditors, after considering all relevant facts and circumstances of each specific situation. Undoubtedly there will be diversity in practice with respect to the interpretation of this requirement. One entity's efforts will certainly not align with another entity's reasonable efforts.

One of the important considerations an entity should ask itself is whether appropriate and sufficient data was collected in prior periods in a way that would in fact allow retrospective application. If it was not, is it impracticable to attempt to recreate the data in such a manner that would sufficiently support retrospective application? In addition, an entity should also consider the relevance of hindsight on the part of management. Can it reliably make assumptions about what management's intentions would have been in a prior period or estimate the amounts recognized, measured, or disclosed? And finally, the entity should consider the cost/benefit of performing a full retrospective application and ask the following question - would trying to recreate history with a different accounting principle be so overly costly that the perceived benefits would not be worth it?

One final important point is that while an entity is required to make a determination of whether information currently available to develop significant estimates would have been available when the affected transactions or events would have been recognized in the financial statements, an entity is not required to maintain documentation from the time that an affected transaction or event would have been recognized to determine whether information to develop the estimates would have been available at that time (ASC 250-10-45-10).

review question…

1. **Each of the following situations is considered an example of an accounting change, except?**
    a. Change in reporting entity.
    b. Change in accounting principle.
    c. Change in accounting estimate.
    d. Change in prior period financial statements.

2. **Which of the following situations is an example of a change in accounting principle?**
    a. A change in an entity's method for valuing its inventory.
    b. A change in an entity's estimated warranty liability.
    c. A change in the estimated useful life of one of the entity's significant assets.
    d. A change in the estimate of excess and obsolete inventory.

Please refer to solution/answer pages at back of booklet

Justifying a Change in Accounting Principle

As we previously noted in Exhibit 1-1, ASC 250 presumes that once an accounting policy is adopted it is used consistently in accounting for similar events or transactions. Additionally, an entity may voluntarily change an accounting principle only if it justifies the use of an allowable alternative accounting principle if it is in fact preferable. Recall, an entity cannot freely change accounting principles in order to receive a more favorable accounting result.

In summary, the key consideration lies with the term “preferable”. Recall that a voluntary change may only result from a change from an acceptable accounting method to a different acceptable accounting method (not from a method that is not considered GAAP). For example, the change in depreciation method, change in the number of pools used in the application of LIFO, or change in the method of applying LIFO from dollar-value LIFO to specific goods LIFO are examples of permissible changes in accounting principles (so long as they are preferable).

In some cases, entities may consider changing an accounting principle to conform to a proposed ASU. For example, generally when the FASB makes significant changes to GAAP (for example, more recently the new revenue recognition standards or the new lease accounting standards), they will usually propose the changes and request feedback from entities and other stakeholders before finalizing the amendments. During this deliberation period, entities may find it appropriate to affect certain changes in their organizations in anticipation of the final amendments. Such a proposed amendment to GAAP should not be used as the basis for a voluntary change in accounting principle. This is primarily because proposed amendments to GAAP remain subject to change in the process of developing and approving the final amendments.

A decision by an entity to make a voluntary change of an accounting principle requires management as well as the entity’s auditors to establish preferability of the change. The Public Company Accounting Oversight Boards (PCAOB) Auditing Standard No. 6, Evaluating Consistency of Financial Statements, states that an auditor should evaluate a change in accounting principle to determine whether:

- The newly adopted accounting principle is a generally accepted accounting principle
- The method of accounting for the effect of the change is in conformity with generally accepted accounting principles
- The disclosures related to the accounting change are adequate
- -The company has justified that the alternative accounting principle is preferable

However, while there is specific guidance for independent auditors of public business entities in assessing the preferability of an accounting principle change, very little guidance in the accounting literature exists for evaluating the reasonableness of management’s justification for a voluntary change in accounting principle. One of the few examples is included within ASC 330-10-30-14 which discusses methods of costing inventory as illustrated in Exhibit 1-3. This ASC topic offers some general guidance on preferability, as follows:

Exhibit 1-3: ASC 330-10-30-14

Although selection of the method should be made on the basis of the individual circumstances, financial statements will be more useful if uniform methods of inventory pricing are adopted by all entities within a given industry.

One of the overall principles is that preferability among accounting principles should be determined on the basis of whether the new principle constitutes an improvement in financial reporting and not on the basis of the income tax effect alone (ASC 250-10-55-1). In other words, by changing to a different accounting principle, is an entity better reflecting the economics of a certain transaction.

While there is limited guidance as noted above, the Securities & Exchange Commission (SEC) does provide certain considerations with respect to preferability changes. These seven questions and interpretive responses provided by the SEC and codified within ASC 250-10-S99-4 are provided below in Exhibit 1-4.

Exhibit 1-4: SEC Guidance on Preferability on Accounting Principle Changes

Facts

Rule 10-01(b)(6) of Regulation S-X requires that a registrant who makes a material change in its method of accounting shall indicate the date of and the reason for the change. The registrant also must include as an exhibit in the first Form 10-Q filed subsequent to the date of an accounting change, a letter from the registrant's independent accountants indicating whether or not the change is to an alternative principle which in his judgment is preferable under the circumstances. A letter from the independent accountant is not required when the change is made in response to a standard adopted by the Financial Accounting Standards Board which requires such a change.

Question 1

For some alternative accounting principles, authoritative bodies have specified when one alternative is preferable to another. However, for other alternative accounting principles, no authoritative body has specified criteria for determining the preferability of one alternative over another. In such situations, how should preferability be determined?

Interpretive Response

In such cases, where objective criteria for determining the preferability among alternative accounting principles have not been established by authoritative bodies, the determination of preferability should be based on the particular circumstances described by and discussed with the registrant. In addition, the independent accountant should consider other significant information of which he is aware.

Question 2

Management may offer, as justification for a change in accounting principle, circumstances such as: their expectation as to the effect of general economic trends on their business (e. g., the impact of inflation), their expectation regarding expanding consumer demand for the company's products, or plans for change in marketing methods. Are these circumstances which enter into the determination of preferability?

Interpretive Response

Yes. Those circumstances are examples of business judgment and planning and should be evaluated in determining preferability. In the case of changes for which objective criteria for determining preferability have not been established by authoritative bodies, business judgment and business planning often are major considerations in determining that the change is to a preferable method because the change results in improved financial reporting.

(Exhibit 1-4 continued)

Question 3

What responsibility does the independent accountant have for evaluating the business judgment and business planning of the registrant?

Interpretive Response

Business judgment and business planning are within the province of the registrant. Thus, the independent accountant may accept the registrant's business judgment and business planning and express reliance thereon in his letter. However, if either the plans or judgment appear to be unreasonable to the independent accountant, he should not accept them as justification. For example, an independent accountant should not accept a registrant's plans for a major expansion if he believes the registrant does not have the means of obtaining the funds necessary for the expansion program.

Question 4

If a registrant, who has changed to an accounting method which was preferable under the circumstances, later finds that it must abandon its business plans or change its business judgment because of economic or other factors, is the registrant's justification nullified?

Interpretive Response

No. A registrant must in good faith justify a change in its method of accounting under the circumstances which exist at the time of the change. The existence of different circumstances at a later time does not nullify the previous justification for the change.

Question 5

If a registrant justified a change in accounting method as preferable under the circumstances, and the circumstances change, may the registrant revert to the method of accounting used before the change?

Interpretive Response

Any time a registrant makes a change in accounting method, the change must be justified as preferable under the circumstances. Thus, a registrant may not change back to a principle previously used unless it can justify that the previously used principle is preferable in the circumstances as they currently exist.

(Exhibit 1-4 continued)

Question 6

If one client of an independent accounting firm changes its method of accounting and the accountant submits the required letter stating his view of the preferability of the principle in the circumstances, does this mean that all clients of that firm are constrained from making the converse change in accounting (e. g., if one client changes from FIFO to LIFO, can no other client change from LIFO to FIFO)?

Interpretive Response

No. Each registrant must justify a change in accounting method on the basis that the method is preferable under the circumstances of that registrant. In addition, a registrant must furnish a letter from its independent accountant stating that in the judgment of the independent accountant the change in method is preferable under the circumstances of that registrant. If registrants in apparently similar circumstances make changes in opposite directions, the staff has a responsibility to inquire as to the factors which were considered in arriving at the determination by each registrant and its independent accountant that the change was preferable under the circumstances because it resulted in improved financial reporting. The staff recognizes the importance, in many circumstances, of the judgments and plans of management and recognizes that such management judgments may, in good faith, differ. As indicated above, the concern relates to registrants in apparently similar circumstances, no matter who their independent accountants may be.

Question 7

If a registrant changes its accounting to one of two methods specifically approved by the FASB in the Accounting Standards Codification, need the independent accountant express his view as to the preferability of the method selected?

Interpretive Response

If a registrant was formerly using a method of accounting no longer deemed acceptable, a change to either method approved by the FASB may be presumed to be a change to a preferable method and no letter will be required from the independent accountant. If, however, the registrant was formerly using one of the methods approved by the FASB for current use and wishes to change to an alternative approved method, then the registrant must justify its change as being one to a preferable method in the circumstances and the independent accountant must submit a letter stating that in his view the change is to a principle that is preferable in the circumstances.

You will note that some of the interpretive guidance provided by the SEC above not only includes guidance for entities but also discusses some of the responsibilities for an entity's independent accountant (i.e. the auditor). For example, Questions 3, 6, and 7 address some of the responsibilities of the auditor. While an expanded discussion of the auditor's requirements are outside the scope of this course, the user should nonetheless be familiar with the requirements because an entity that affects a change in accounting principle on the basis of preferability will undoubtedly have to defend this position with its auditor.

Preferability Letter

You will note from the interpretive response to question 7 in Exhibit 1-4 that when an entity elects to change from one acceptable accounting principle to another acceptable accounting principle, the auditor is required to submit a letter stating that based on their review they agree that the change in preferable. Further to this point, when an SEC registrant (note the distinction here that we are talking about public companies and not private companies) makes a voluntary change in accounting principle, it generally is required to include a preferability letter issued by its independent registered public accounting firm as Exhibit 18 to its first periodic report filed subsequent to the accounting change. As a result, this would either be through its Quarterly Report on Form 10-Q if the change is made in an interim period other than the fourth quarter or the entity's Annual Report on Form 10-K if the change is made in the fourth quarter. The SEC staff has taken the position that a preferability letter is needed for each situation in which a registrant discloses a voluntary change in accounting principle, even though the auditors may consider the change to not be material and do not comment about the change in accounting principle in their report.

One specific example the SEC cites as example of a situation where a preferability letter historically was required to be included relates to an entity's goodwill impairment testing date. Based on the goodwill impairment guidance in ASC 350, goodwill is to be tested at the same date each year (commonly entities selected a time period in the early part of their fourth quarters). In a December 2014 speech at the AICPA Conference on Current SEC and PCAOB Developments, Carlton Tartar, Associate Chief Accountant, Office of the Chief Accountant, an SEC staff member, discussed how in the past the SEC viewed a change in the goodwill impairment testing date as a change in accounting principle and required that a preferability letter from the auditor be included. However, the SEC has relaxed their interpretation of this requirement and instead placed reliance on the entity to determine whether the change in the goodwill impairment testing date represents a material change to its method of applying an accounting principle. Refer to Exhibit 1-5 below which includes an excerpt from the SEC speech that discusses this situation in additional detail.

Exhibit 1-5: SEC Speech on Goodwill Impairment Testing Date Change

The staff observes that goodwill is required to be tested at the same date each year in Topic 350, while indefinite lived intangible assets do not have a similar requirement. This difference was the rationale for the staff historically requesting a preferability letter for a change in goodwill impairment testing date, since a change in testing date was viewed to be a change in the method of applying an accounting principle. As the FASB has requested input regarding potential areas where US GAAP can be simplified, this may be an area where stakeholders may want to comment. Absent any changes to US GAAP, the staff has observed that some registrants may view a change in goodwill impairment testing date to not represent a material change to a method of applying an accounting principle, even if goodwill is material to the financial statements, because the change in impairment testing date is not viewed to have a material effect on the financial statements in light of the registrant's internal controls and requirements under Topic 350 to assess goodwill impairment upon certain triggering events. The staff acknowledges that judgment is required when assessing materiality and the assessment of whether a change in accounting principle is material may include considerations beyond the quantitative significance of the financial statement line items. Accordingly, if a registrant determines that a change in goodwill impairment testing date does not represent a material change to its method of applying an accounting principle, the staff will no longer request a preferability letter to be obtained and filed, provided that such change is prominently disclosed in the registrant's financial statements. The staff also reserves the right to ask questions based on the registrant's specific facts and circumstances, which may include situations where it appears that a registrant's goodwill impairment testing date is frequently changed.

Accounting Changes in Interim Periods

ASC 250 requires that a change in accounting principle made in an interim period (i.e. quarterly period) be reported by retrospective application similar to those changes made during an annual period. This retrospective application would apply both to the prior years, as well as to the interim periods within the fiscal year that the accounting change was adopted.

However, there is one notable difference. The impracticability exception provided in ASC 250-10-45-9 cannot be applied to the interim periods of the fiscal year in which the accounting change is made. When an entity determines that retrospective application to the pre-change interim periods of the fiscal year of the change is impracticable, the desired change may only be made as of the beginning of the subsequent fiscal year.

Change in Accounting Principle – Illustrative Example

The implementation guidance (subtopic 55) within ASC 250 contains a comprehensive example for how a change in accounting principle is reflected. In this section, this example will be illustrated to further solidify your understanding of the requirements for changes in accounting principles.

In the example below, an entity has elected to adopt the FIFO method of inventory valuation. Previously, the entity used the LIFO method for financial and tax reporting since its inception on January 1, 20X5, and had maintained records that are adequate to apply the FIFO method retrospectively. The entity concluded that the FIFO method is the preferable inventory valuation method for its inventory. As a result, the effects of the change in accounting principle on inventory and cost of sales are presented in the following table excerpted from ASC 250-10-55-4:

	Inventory Determined by		Cost of Sales Determined by	
Date	LIFO Method	FIFO Method	LIFO Method	FIFO Method
1/1/20X5	$ -	$ -	$ -	$ -
12/31/20X5	100	80	800	820
12/31/20X6	200	240	1,000	940
12/31/20X7	320	390	1,130	1,100

In addition, the example is also based on the following assumptions (ASC 250-10-55-5):

- For each year presented, sales are $3,000 and selling, general, and administrative costs are $1,000. The entity's effective income tax rate for all years is 40 percent, and there are no permanent or temporary differences.
- The entity has a nondiscretionary profit-sharing agreement in place for all years. Under that agreement, the entity is required to contribute 10 percent of its reported income before tax and profit sharing to a profit-sharing pool to be distributed to employees. For simplicity, it is assumed that the profit-sharing contribution is not an inventoriable cost.
- The entity determined that its profit-sharing expense would have decreased by $2 in 20X5 and increased by $6 in 20X6 if it had used the FIFO method to compute its inventory cost since inception. The terms of the profit-sharing agreement do not address whether the entity is required to adjust its profit-sharing accrual for the incremental amounts. At the time of the accounting change, the entity decides to contribute the additional $6 attributable to 20X6 profit and to make no adjustment related to 20X5 profit. The $6 payment is made in 20X7.
- Profit sharing and income taxes accrued at each year-end under the LIFO method are paid in cash at the beginning of each following year.

- The entity's annual report to shareholders provides two years of financial results, and the entity is not subject to the requirements of the earnings per share accounting literature.

Furthermore, the entity's income statement before the change in accounting is included in the following illustration below (ASC 250-10-55-8):

	20X6	20X5
Sales	$ 3,000	$ 3,000
Cost of goods sold	1,000	800
Selling, general, and administrative expenses	1,000	1,000
Income before profit sharing and income taxes	1,000	1,200
Profit sharing	100	120
Income before income taxes	900	1,080
Income taxes	360	432
Net income	$ 540	$ 648

Subsequent to the retrospective application, the entity's restated income statement is prepared as illustrated below (ASC 250-10-55-10):

	20X7	20X6 As Adjusted (Note A)
Sales	$ 3,000	$ 3,000
Cost of goods sold	1,100	940
Selling, general, and administrative expenses	1,000	1,000
Income before profit sharing and income taxes	900	1,060
Profit sharing	96	100
Income before income taxes	804	960
Income taxes	322	384
Net income	$ 482	$ 576

Disclosures Required for Changes in Accounting Principles

ASC 250-10-50-1 requires that certain disclosures be made by an entity in the fiscal period in which a change in accounting principle is made. This includes disclosure of the following (ASC 250-10-50-1)

- The nature of and reason for the change in accounting principle, including an explanation of why the newly adopted accounting principle is preferable
- The method of applying the change, including all of the following:
  - A description of the prior-period information that has been retrospectively adjusted, if any
  - The effect of the change on income from continuing operations, net income, any other affected financial statement line item, and any affected per-share amounts for the current period and any prior periods retrospectively adjusted
  - The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented
  - If retrospective application to all prior periods is impracticable, disclosure of the reasons therefore, and a description of the alternative method used to report the change
- If indirect effects of a change in accounting principle are recognized, both of the following should be disclosed:
  - A description of the indirect effects of a change in accounting principle, including the amounts that have been recognized in the current period, and the related per-share amounts, if applicable
  - Unless impracticable, the amount of the total recognized indirect effects of the accounting change and the related per-share amounts, if applicable, that are attributable to each prior period presented. Compliance with this disclosure requirement is practicable unless an entity cannot comply with it after making every reasonable effort to do so

It is important to note that the financial statements of subsequent periods are not required to repeat the required disclosures initially made in the period of an accounting change. However, entities that issue interim financial statements are required to provide the required disclosures in the financial statements of both the interim and annual periods that include the direct or indirect effects of a change in accounting principle.

Example Disclosure

Continuing our illustrative example from above, ASC 250-10-50-11 includes the following example of the qualitative disclosure that the entity would make within its note to its financial statements:

> "On January 1, 20X7, Entity A elected to change its method of valuing its inventory to the FIFO method, whereas in all prior years inventory was valued using the LIFO method. The new method of accounting for inventory was adopted [state justification for change in accounting principle] and comparative financial statements of prior years have been adjusted to apply the new method retrospectively. The following financial statement line items for fiscal years 20X7 and 20X6 were affected by the change in accounting principle."

As noted in the example above, the entity references financial statement line items for the current preceding years that were affected by the change in accounting principle. Included below is a partial excerpt of one of these illustrations that align with the disclosure above. For purposes of our course, not all exhibits which illustrate the effect of the change in accounting

principle are provided. Refer to ASC 250-10-50-11 for a comprehensive overview of those related financial statement exhibits.

Income Statement

20X7

	As Computed under LIFO	As Reported under FIFO	Effect of Change
Sales	$ 3,000	$ 3,000	$ -
Cost of goods sold	1,130	1,100	(30)
Selling, general, and administrative expenses	1,000	1,000	-
Income before profit sharing and income taxes	870	900	30
Profit sharing	87	96 (a)	9
Income before income taxes	783	804	21
Income taxes	313	322	9
Net income	$ 470	$ 482	$ 12

(a) This amount includes a $90 profit-sharing payment attributable to 20X7 profits and $6 profit-sharing payment attributable to 20X6 profits, which is an indirect effect of the change in accounting principle. The incremental payment attributable to 20X6 would have been recognized in 20X6 if Entity A's inventory had originally been accounted for using the FIFO method.

Change in Accounting Estimate

The previous sections have addressed the first type of accounting change – a change in accounting principle. In this section, we address the next type of accounting change – a change in accounting estimate. Examples of a change in accounting estimate include, but are not limited to, the following:

- Change in estimated liability for warranties;
- Change in the estimated useful life or salvage value of a long-lived asset;
- Change in method of depreciating long-lived assets;
- Change in estimated allowance for loan losses or bad debts;
- Change in estimates of obsolete and excess inventory;

One of the distinguishing characteristics between a changes in accounting principle versus changes in accounting estimates is the way in which the change is reflected in an entity's financial statements. Recall that for a change in accounting principle, the change is required to be retrospectively reflected unless it is impractical to do. Alternatively, a change in accounting estimate is required to be accounted for in the period of change if the change affects that period only or in the period of change and future periods if the change affects both (ASC 250-10-45-17). In other words, a change in accounting estimate should not be accounted for by restating or retrospectively adjusting amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods. This is one of the key differences between that of a change in accounting principle versus a change in accounting estimate.

ASC 250-10-45-18 also notes that distinguishing between a change in an accounting principle and a change in an accounting estimate can sometimes be difficult as a change in accounting estimate can be effected by a change in accounting principle in some cases. An example of this type of change is a change in method of amortization, depreciation, or depletion of long-lived, nonfinancial assets. The effect of the change in accounting principle, or the method of applying it, may be inseparable from the effect of the change in accounting estimate given that the new depreciation method is either adopted in partial or complete recognition of a change in the estimated future benefits of the asset. As a result, changes of this type often are related to the continuing process of obtaining additional information and revising estimates and as a result, should be considered changes in estimates.

Disclosures

Disclosure requirements with respect to a change in accounting estimate depends on whether or not the change is material to the financial statement. If the change is not material and it is in the ordinary course of accounting, there are no additional disclosure requirements. The entity simply makes the change and proceeds forward with business as usual. Examples of this "ordinary course of business" notation would be related to a change in estimate uncollectible accounts receivables and inventory obsolescence.

However, when the change in accounting estimate is in fact material to an entity's financial statements, an entity is required to disclose the effect on each of the following as a result of an estimate that affects several future periods (ASC 250-10-50-4):

- Income from continuing operations
- Net income
- Any related per-share amounts

However, there is a seemingly middle ground in between the two situations referenced above. If a change in an estimate does not have a material effect in the period of change, but it is reasonably certain to have a material effect in later periods, an entity is required to include a description of the change in estimate when those financial statements of the period of change are actually presented. Exhibit 1-6 below contains an example of this type of disclosure.

Exhibit 1-6: Example Disclosure

On an ongoing basis, the entity reviews the estimated useful lives of its fixed assets. Based on the recent results of its review, the entity determined that the actual lives of certain machinery and equipment at its operating location were longer than the estimated useful lives used for depreciation purposes in its financial statements. As a result, effective January 1, 2015, the entity changed its estimates of the useful lives of its machinery and equipment to better reflect the estimated periods during which these assets will remain in service and operating. The estimated useful lives of the machinery and equipment that previously averaged seven years were increased to an average of 12 years, while those that previously averaged four to six years were increased to an average of 11 years. The effect of this change in estimate was to reduce 2016 depreciation expense by $450,000, increase 2016 net income by $360,000, and increase 2016 basic and diluted earnings per share by $0.13.

Change in Reporting Entity

The final type of accounting change is a change in reporting entity. Included below is a listing of common examples of a change in reporting entity (ASC 250-10-20):

- Presenting consolidated or combined financial statements in place of financial statements of individual entities;
- Changing specific subsidiaries that make up the group of entities for which consolidated financial statements are presented;
- Changing the entities included in combined financial statements;

While ASC 250 provides examples of what is considered a change in reporting entity, it also makes mention of two types of events/transactions that are not considered a change in reporting entity. This includes each of the following:

- Consolidation of a variable interest entity;
- Business combinations accounted for by the acquisition method;

When an entity has a change in reporting entity, ASC 250-10-45-21 prescribes that an entity reflect a change in the reporting entity by retrospective application to the financial statements of all prior periods presented to show financial information for the new reporting entity. In addition, the change in reporting entity should also be applied to interim financial information previously issued on a retrospective basis. Note, this treatment is similar to the requirements with respect to a change in accounting principle.

One exception to this requirement relates to capitalized interest. In this situation, the amount of interest cost previously capitalized through application should not be changed when retrospectively applying the accounting change to the financial statements of prior periods (ASC 250-10-45-21).

Disclosures

Simply put, if an entity has change in its reporting entity, the entity is required to disclose the following (ASC 250-10-50-4-6):

- The nature of the change and the reason for it
- The effect of the change on income from continuing operations, net income, other comprehensive income, and any related per-share amounts for all periods presented

It should also be noted that financial statements of subsequent periods are not required to repeat these disclosures. Similar to changes in accounting estimates, if a change in reporting entity does not have a material effect in the period of change but is reasonably certain to have a material effect in later periods, the nature of and reason for the change should be disclosed whenever the financial statements of the period of change are presented (ASC 250-10-50-6).

review question...

3. Which of the following identifies a required disclosure with respect to a material change in an accounting estimate?

a. The cumulative effect on comprehensive income.
b. The effects on any related per-share related amounts.
c. The effects on prior period financial information.
d. The nature of and reasons for the change.

Please refer to solution/answer pages at back of booklet

Accounting for Correction of Errors

All of the discussions leading up to this point have focused on accounting changes, whether it be a change in accounting estimate, a change in accounting principle, or a change in reporting entity. We now shift gears and move onto the considerations and accounting/reporting requirements with respect to correction of errors. One of the primary principles to keep in mind regarding a correction of error is that the way in which the correction of error is accounted for is very dependent on the materiality. In other words, if a correction is determined to be immaterial, it is generally

corrected in the current period and the process ends there. However, if it is determined to be material, full restatement of the previous financial statements may be required. An overview of the general process for assessing a correction of an error is provided in the illustration below.

Each of the above processes are discussed in more detail in the following sections.

Determine if an Error Exists

Before going too far into the discussion of the accounting and reporting requirements related to correction of errors, we need to first spend time differentiating a correction of an error from that of a change in accounting estimate, a reclassification, and a change in accounting principle. As a result, we need to actually make the determination of whether an error actually exists or if instead of an error, the entity has a change in accounting estimate, an acceptable reclassification, or a change in accounting principle.

In certain situation, it can be difficult to distinguish an error from a change in accounting estimate. As defined in the ASC Master Glossary, a change in accounting estimate is a change that has the effect of adjusting the carrying amount of an existing asset or liability or altering the subsequent accounting for existing or future assets or liabilities. Developing and applying accounting estimates is a fundamental part of accounting and financial reporting and numerous accounting pronouncements require entities to develop accounting estimates and assess the underlying assumption on an ongoing basis. As a result, estimates will and should change over time as new information and experience develops. However, the fact that the accounting treatment involves an estimation process does not mean that all changes related to an estimation process are changes in estimates. If the actual results do not support the assumptions used to develop the accounting estimate, an entity should evaluate whether an error has occurred. In summary, determining whether an adjustment is a change in accounting estimate or an error requires the use of professional judgment and assessment of the particular facts and circumstances.

With respect to reclassifications, this is a change in classification of the amount presented in financial statements to ensure comparability of the current period to prior periods. A reclassification is a change from one presentation that complies with GAAP to another presentation that complies with US GAAP, whereas a correction of an error would result when a presentation does not comply with US GAAP and is changed to a presentation that does in fact comply with US GAAP.

The same can also be said for a change in accounting principle as we discussed extensively in the previous sections. Changing from a GAAP compliant accounting principle to another GAAP compliant accounting principle is not an error correction. It is a change in accounting principle.

Determine if an Error Exists

If an entity concludes that an error has occurred, the next step in the process is to assess the materiality of the error. It goes without saying that materiality is a key concept with respect to financial reporting. However, the FASB Codification provides limited guidance on assessing the materiality of financial statement errors. While ASC 250-10-45-27 relates to interim periods, it is the only authoritative FASB guidance that discusses assessing materiality of errors and notes that the determination of whether an error is material should be related to the estimated annual income and the trend of earnings. Additionally, the FASB Concepts Statement 2, Qualitative Characteristics of Accounting Information, also discusses materiality and provides some insight as to the lack of prescriptive materiality guidance and the use of judgment when assessing materiality. However, as you will note, the Concept Statements are non-authoritative.

The SEC staff, however, provides further guidance on materiality through its publication of two Staff Accounting Bulletins (SABs). Both of which are codified within ASC 250-10-S99.

- SAB Topic 1.M (SAB 99) which states that the assessment of the materiality of errors should consider both qualitative and quantitative considerations and discusses more specific aspects of the qualitative considerations;
- SAB Topic 1.N (SAB 108) which addresses quantifying the financial statement effects of errors (i.e., the quantitative analysis) and provides guidance on the correction of errors, including the correction of immaterial errors existing in prior period financial statements.

Based on the combination of these SAB topics above, it is noted that a materiality analysis includes each of the following processes:

- Qualitative analysis;
- Quantitative analysis to include the following:
  - Iron curtain method; and
  - Rollover method

Qualitative Analysis

With respect to the qualitative analysis, there may be instances where a misstatement is small, but based on qualitative aspects, it could be considered material. Included within ASC 250-10-S99-1 is a listing of the considerations that may render a qualitatively small misstatement material. This includes whether the misstatement:

- Arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate
- Masks a change in earnings or other trends
- Hides a failure to meet analysts' consensus expectations for the enterprise
- Changes a loss into income or vice versa
- Concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability
- Affects the registrant's compliance with regulatory requirements
- Affects the registrant's compliance with loan covenants or other contractual requirements
- Has the effect of increasing management's compensation — for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation
- Involves concealment of an unlawful transaction.

Said another way, an entity may identify an immaterial correction of an error, but if the error involved the concealment of an unlawful transaction or affects the entity's compliance with regulatory requirements, the fact that the error was immaterial potentially goes to the wayside. Picture yourself in the shoes of an investor or another stakeholder of an entity, would you want to be made aware of an error of this nature, even if it related to an immaterial amount? Certainly so as this would potentially call into question the integrity of the entity's management.

The SEC cautions that the listing above should not be regarded as an exhaustive list. In other words, it would be inappropriate for an entity to use this as a checklist and conclude that if an immaterial error did not meet one of the events above, it would not be considered qualitatively material. The decision on whether an immaterial correction of an error is qualitatively material, like many issues within GAAP, is a matter of professional judgement. However, the entity should also ask itself the question – would a possible investor want to know about this? Chances are, if the answer to this question is a resounding yes, then it is likely that the error warrants disclosure and further analysis.

In addition to the analysis above, there are additional considerations with respect to the qualitative analysis. This includes the following considering small intentional misstatements, segment reporting effects, and aggregation/netting.

Small intentional misstatements is another area of concern for the SEC. As noted in Exhibit 1-7 below from ASC 250-10-S99-1, entities cannot simply assume that given the misstatement is immaterial that it does not rise to the level of being material. Especially if it is intentional and performed in such a way to manage earnings.

Exhibit 1-7: Small Intentional Misstatements

The staff believes that a registrant and the auditors of its financial statements should not assume that even small intentional misstatements in financial statements, for example those pursuant to actions to "manage" earnings, are immaterial. While the intent of management does not render a misstatement material, it may provide significant evidence of materiality.

The evidence may be particularly compelling where management has intentionally misstated items in the financial statements to "manage" reported earnings. In that instance, it presumably has done so believing that the resulting amounts and trends would be significant to users of the registrant's financial statements.

The staff believes that investors generally would regard as significant a management practice to over- or under-state earnings up to an amount just short of a percentage threshold in order to "manage" earnings. Investors presumably also would regard as significant an accounting practice that, in essence, rendered all earnings figures subject to a management-directed margin of misstatement.

Additionally, the effect of an error to segment information, from both a quantitative and qualitative standpoint, should also be considered as part of the entity's analysis of the effect on the financial statements taken as a whole. For example, a misstatement of the revenue and operating profit of a relatively small segment that is represented by management to be important to the future profitability of the entity is more likely to be material to investors than a misstatement in a segment that management has not identified as especially important (ASC 250-10-S99-1).

Finally, entities should also consider each misstatement separately and in the aggregate of all other misstatements identified. The ASC further prescribes that entities and their auditors should first consider whether each misstatement is material, irrespective of its effect when combined with other misstatements. Note that even though a misstatement of an individual amount may not cause the financial statements taken as a whole to be materially misstated, it may nonetheless, when aggregated with other misstatements, render the financial statements taken as a whole to be materially misleading (ASC 250-10-S99-1).

Iron Curtain Method

The iron curtain method, along with the rollover method (which will be discussed next) is one of the most commonly used techniques to accumulate and

quantify misstatements. Based on ASC 250-10-S99-2, the iron curtain method quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the current year, irrespective of the misstatements year(s) of origination. Refer to Exhibit 1-8 which provides an example of the application of this method (ASC 250-10-S99-2).

Exhibit 1-8: Iron Curtain Method (ASC 250-10-S99-2)

Facts

During the course of preparing annual financial statements, a registrant is evaluating the materiality of an improper expense accrual (e.g., overstated liability) in the amount of $100, which has built up over 5 years, at $20 per year. The registrant previously evaluated the misstatement as being immaterial to each of the prior year financial statements (i.e., years 1-4). For the purpose of evaluating materiality in the current year (i.e., year 5), the registrant quantifies the error as a $20 overstatement of expenses.

Interpretive Response

The iron curtain approach quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the current year, irrespective of the misstatements year(s) of origination. Had the registrant in this fact pattern applied the iron curtain approach, the misstatement would have been quantified as a $100 misstatement based on the end of year balance sheet misstatement. Thus, the adjustment needed to correct the financial statements for the end of year error would be to reduce the liability by $100 with a corresponding decrease in current year expense.

The primary weakness of the iron curtain approach is that it does not consider the correction of prior year misstatements in the current year (i.e., the reversal of the carryover effects) to be errors. Therefore, in this example, if the misstatement was corrected during the current year such that no error existed in the balance sheet at the end of the current year, the reversal of the $80 prior year misstatement would not be considered an error in the current year financial statements under the iron curtain approach. Implicitly, the iron curtain approach assumes that because the prior year financial statements were not materially misstated, correcting any immaterial errors that existed in those statements in the current year is the correct accounting, and is therefore not considered an error in the current year. Thus, utilization of the iron curtain approach can result in a misstatement in the current year income statement not being evaluated as an error at all.

As you can note from the example in Exhibit 1-8 above, the iron curtain method is limited in that it does not consider the correction of the period year misstatements in current year. Said another way, the iron curtain method assumes that the prior year financial misstatements were not materially misstated, and as a result, an entity is allowed to correct those immaterial errors within the current year.

Rollover Method

The rollover method quantifies a misstatement based on the amount of the error originating in the current year income statement (ASC 250-10-S99-2). As a result, this approach ignores the effects of correcting the portion of the current year balance sheet misstatement that originated in prior years (i.e., it ignores the carryover effects of prior year misstatements). Where the iron curtain method lacks, the rollover method compensates. As a result, the SEC notes that exclusive reliance on one method biased toward either the income statement or the balance sheet is inappropriate. Instead, companies should quantify the effects of the misstatement using both the iron curtain method and the rollover method.

However, the rollover method is not perfect and also has its inherent weaknesses. Refer to the following excerpt sourced from ASC 250-10-S99-2 which addresses the inherent weakness of the rollover method:

> "The primary weakness of the rollover approach is that it can result in the accumulation of significant misstatements on the balance sheet that are deemed immaterial in part because the amount that originates in each year is quantitatively small. The staff is aware of situations in which a registrant, relying on the rollover approach, has allowed an erroneous item to accumulate on the balance sheet to the point where eliminating the improper asset or liability would itself result in a material error in the income statement if adjusted in the current year. Such registrants have sometimes concluded that the improper asset or liability should remain on the balance sheet into perpetuity."

Report the Error

The third and final step to the error correction analysis relates to actually reporting the error, if applicable. Recall that if the correction is immaterial, in most cases only a correction in the current period financial statement is required with no additional disclosures. As you can imagine, as the materiality of the error increases, so too does the considerations around the method in which it should be reported and what is required by the entity.

Let's first address the situation where when completing both the iron curtain method and rollover method analysis, the entity determines that there is no restatement implications. Said another way, the error is immaterial to both prior periods and the current period. In this situation, the entity is generally allowed to correct the error in the current period with no restatement implications.

However, what about cases in which the correction of

the error is material to either the prior period or current periods, or both. If the correction is material to prior periods, this results in what is commonly referred to as a "Big R Restatement". Alternatively, when the correction is material to the current period only, and not the prior period, this is commonly referred to as a "Little R Restatement". A discussion of each of these types of restatements follows.

Big R Restatement

When a Big R Restatement occurs, the restatement corrects all material errors including the correction of material errors relating to classification and disclosure. In addition, a Big R restatement requires an entity to revise previously issued financial statements. As a result, the entity would generally be required to file a Form 10-K/A to reflect the correction of the error in those prior period financial statements. In situations where an entity concludes a Big R restatement is appropriate and necessary, the prior financial statements cannot be relied upon and therefore, the entity must notify users of the financial statements that those financial statements can no longer be relied upon. Simply put, this is not something an entity would like to do.

Little R Restatement

When a Little R Restatement occurs, an error is immaterial to the prior period financial statements, but making the correction of the error in the current period would materially misstate the current period financial statements. In other words, the turn-around effect of the error correction is material to the current period income statement or statement of comprehensive income. This type of restatement is common when an immaterial error remains uncorrected for multiple periods and aggregates to a material figure that, when corrected, is material to the current period.

Given that correcting the error in the current year would materially misstate the current period financial statements, the prior period financial statements should also be corrected, even though such revision previously was and continues to be immaterial to the prior period financial statements. The key difference with the Little R Restatement compared to the Big R Restatement is that it does not require that previous filings be amended. In other words, the entity is not to amend its Form 10-K through a Form 10-K/A filing as discussed above. Instead, the prior period correction may be made the next time the entity files the prior period financial statements with its current period financial statements. The result is that the entity corrects the error in the current period financial statements by adjusting the prior period information and adding disclosure of the error.

One other key difference with the Little R Restatement is that because the prior period financial statements were not materially misstated, the entity is not required to notify users that they can no longer rely on the prior financial statements. In addition, the auditor's opinion is not modified when the prior period information is next presented.

Disclosures for Big R Restatements

Specific disclosure requirements are only prescribed for Big R Restatements previously discussed. These requirements are prescribed within ASC 250-10-50-7 through 50-11 and are summarized below.

When financial statements are restated to correct an error, the entity is required to disclose the following:

- A statement that its previously issued financial statements have been restated;
- A description of the nature of the error.
- The effect of the correction on each financial statement line item and any per-share amounts affected for each prior period presented
- The cumulative effect of the change on retained earnings or other appropriate components of equity or net assets in the statement of financial position, as of the beginning of the earliest period presented.

In addition, when prior period adjustments are recorded, the resulting effects on the net income of prior periods are required to be disclosed in the annual report for the year in which the adjustments are made and in interim reports issued during that year subsequent to the date of recording the adjustments. This presentation should give effect to both the gross and net presentation of applicable income tax.

Furthermore, when financial statements for a single period only are presented, the entity should disclose that the effects of such restatement on both of the following:

- The balance of retained earnings at the beginning of the period;
- The net income of the immediately preceding period;

When financial statements for more than one period are presented, which is ordinarily the preferable procedure, the disclosure should include the effects for each of the periods included in the statements. In addition, such disclosures should include the amounts of income tax applicable to the prior period adjustments.

Internal Control Considerations

When an entity has an accounting change or error correction, it is advisable that the entity also consider the effects on the entity's internal controls. In this section of the course we discuss these considerations

starting with those related to correction of errors below, but also discuss the considerations of internal controls with respect to changes in accounting principles and changes in accounting estimates.

Corrections of Errors

An additional consideration that we have not discussed with respect to error corrections is the entity's consideration of its internal control over financial reporting in light of the error identified. Simply put, all entities (either public business entities or private entities) that identify an error in their financial statements should consider how the identified error affects their conclusions about the effectiveness of the related internal controls over financial reporting. It's important to note also that this evaluation of internal control should be performed even when the error does not require restatement because the error may indicate that some aspect of the internal control design or execution was not functioning properly. In other words, a control deficiency still exists. While internal controls should absolutely be assessed and reviewed when a correction of an error leads to a Big R restatement, the same principle holds true when no restatement is required.

If based on the evaluation, the entity concludes that a deficiency does exist, the entity should consider whether it represents either a significant deficiency or a material weakness, or to a lesser extent, simply a deficiency. It's important to note that a deficiency does not have to result in a material misstatement in order for it to be considered a material weakness. Instead, the entity's evaluation should consider the likelihood that the identified deficiency could have resulted in a material misstatement, not that it actually did. In other words, an entity should consider the worst case scenario for the most part when performing this evaluation. An entity's assessment of the significance of a deficiency should also consider the existence of any mitigating controls, whether these controls could have prevented or detected the error, as well as whether the entity has evidence that the mitigating controls were operating effectively.

For SEC registrants subject to management's annual requirement to assess and report on internal control over financial reporting, an error that results in a restatement of previously issued financial statements to correct a material misstatement represents an indicator of a material weakness. Based on the SEC's guidance regarding Management's Report on Internal Control over Financial Reporting under Section 13(a) and 15(d) of the Securities Exchange Act of 1934, management should evaluate whether the following situations indicate a deficiency in ICFR exists and, if so, whether it represents a material weakness:

- Identification of fraud, whether or not material, on the part of senior management;
- Restatement of previously issued financial statements to reflect the correction of a material misstatement;
- Identification of a material misstatement of the financial statements in the current period in circumstances that indicate the misstatement would not have been detected by the company's ICFR;
- Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.

Change in Accounting Principle

The related financial statement risks related to changes in accounting principle, including voluntary changes in accounting principle as well as changes required by ASU should often be appropriately mitigated by an entity's internal controls over financial reporting. It's important to note that the concepts included in ASC 250 are pervasive and both transaction-level as well as entity-level controls will often be required to effectively mitigate the risks of material misstatement related to changes in accounting principle.

With respect to entity-level controls, the risk that inconsistent policies are applied is often mitigated through operation of these controls. As an example, multi-national companies will often have a set of worldwide accounting policies and require quarterly confirmation by subsidiaries and other operating units that the policies are consistently applied. These type of subsidiary reporting packages may assist in the identification of a change in policy in a period that may require accounting and reporting under ASC 250.

Alternatively, transaction-level controls are related more to other infrequent transactions. As a result, in a period where a company has a voluntary change in accounting policy, it may be appropriate to document the process for initiating, implementing and reporting the voluntary change and related controls. Controls that may be identified include management's assessment and documentation of the preferability of the proposed voluntary change in accounting policy and review of the calculation of retrospective adjustments.

Change in Accounting Estimate

Financial statement risks related to changes in estimates should be appropriately mitigated by internal controls over financial reporting, similar to the discussion above with respect to change in accounting principle. Management of an entity should understand the significant assumptions, methods, data, and controls related to estimates and how necessary changes in those assumptions, methods and data are timely identified by controls.

A key consideration of the design of controls over the estimation process for a significant account is timely performance. Timely performance ensures that a necessary change in estimate is identified as new information becomes available and is not significantly

delayed. As an example, assume that a company has a control that the accounts receivable aging is reviewed to identify collection issues. The control is designed to mitigate risks to the completeness and valuation assertions associated with the accounts receivable allowance. If this control is not performed on a timely basis, a change in estimate may not be identified as of the end of a reporting period. Consequently, if the change in estimate is identified in a later reporting period, the adjustment may represent the correction of an error and not a change in estimate.

Accounting Standards Updates

As you recall from the introduction section of this course, it was noted that there have been very few amendments included within ASC 250. However, in this final section of the course, we discuss each of these amendments to provide some additional detail on what has been updated over the years, beginning with the most recently issued ASU.

ASU 2015-11

ASU 2015-11, *Inventory (Topic 330): Simplifying the Measurement of Inventory*, as you can note from the title, dealt primarily with the inventory ASC topic. Primarily, this ASU requires entities to measure inventory at the lower of cost and net realizable value (whereas before, it was lower of cost of market wherein market could be defined as several different valuation methods). However, given the updates made in this ASU, the ASC Master Glossary definition of the term "Direct Effects of a Change in Accounting Principle" was also amended. Refer to Exhibit 1-9 below which provides a before and after of this definition.

Exhibit 1-9: "Direct Effects of a Change in Accounting Principle" Definition

Before ASU 2015-11

Those recognized changes in assets or liabilities necessary to effect a change in accounting principle. An example of a direct effect is an adjustment to an inventory balance to effect a change in inventory valuation method. Related changes, such as an effect on deferred income tax assets or liabilities or an impairment adjustment resulting from applying the lower-of-cost-or-market test to the adjusted inventory balance, also are examples of direct effects of a change in accounting principle.

After ASU 2015-11

Those recognized changes in assets or liabilities necessary to effect a change in accounting principle. An example of a direct effect is an adjustment to an inventory balance to effect a change in inventory valuation method. Related changes, such as an effect on deferred income tax assets or liabilities or an impairment adjustment resulting from **applying the subsequent measurement guidance in Subtopic 330-10** to the adjusted inventory balance, also are examples of direct effects of a change in accounting principle.

As you can note from the exhibit above, the change made to the definition was very minimal and simply directs the user to the inventory subtopic instead of noting the lower of cost or market test. As a result, this is simply a conforming amendment to ASC 250.

ASU 2015-01

ASU 2015-01, *Income Statement – Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items,* as you can note from the title, eliminated the concept of extraordinary items from GAAP. This ASU, like the one previously discussed, resulted in a conforming amendment to ASC 250. Specifically, ASC 250-10-50-6 prescribed the following partial excerpt (prior to the ASU):

> "When there has been a change in the reporting entity, the financial statements of the period of the change shall describe the nature of the change and the reason for it. In addition, the effect of the change on income before extraordinary items, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), other comprehensive income, and any related per-share amounts shall be disclosed for all periods presented."

On account of ASU 2015-01, the term extraordinary item noted in the guidance above was removed from this paragraph and replaced simply with income from continuing operations. Again, this ASU resulted simply in conforming amendments to ASC 250 and did not change any of the fundamental principles.

review question...

4. **Which of the following SAB topics provides guidance on correction of errors, including the correction o immaterial errors existing in prior period financial statements?**
   a. SAB 108.
   b. SAB 101.
   c. SAB 105.
   d. SAB 115.

5. **If an entity determines that a Big R Restatement is required, then the entity should fil which of the following SEC forms in order to restate its annual report?**
   a. Form S-4.
   b. Form 11-K.
   c. Form 10-K/A.
   d. Form 10-Q/A.

6. **Which of the following errors may in fact be considered material even if it is quantitatively immaterial?**
   a. It results from a computational error.
   b. It was identified by the entity's independent accountant.
   c. It results from misapplication of a new ASU.
   d. It involves concealment of an unlawful transaction.

Please refer to solution/answer pages at back of booklet

Glossary

Accounting Change

A change in an accounting principle, an accounting estimate, or the reporting entity. The correction of an error in previously issued financial statements is not an accounting change.

Change in Accounting Estimate

A change that has the effect of adjusting the carrying amount of an existing asset or liability or altering the subsequent accounting for existing or future assets or liabilities. A change in accounting estimate is a necessary consequence of the assessment, in conjunction with the periodic presentation of financial statements, of the present status and expected future benefits and obligations associated with assets and liabilities. Changes in accounting estimates result from new information. Examples of items for which estimates are necessary are uncollectible receivables, inventory obsolescence, service lives and salvage values of depreciable assets, and warranty obligations.

Change in Accounting Estimate Effected by a Change in Accounting Principle

A change in accounting estimate that is inseparable from the effect of a related change in accounting principle. An example of a change in estimate effected by a change in principle is a change in the method of depreciation, amortization, or depletion for long-lived, nonfinancial assets.

Change in Accounting Principle

A change from one generally accepted accounting principle to another generally accepted accounting principle when there are two or more generally accepted accounting principles that apply or when the accounting principle formerly used is no longer generally accepted. A change in the method of applying an accounting principle also is considered a change in accounting principle.

Change in Reporting Entity

A change that results in financial statements that, in effect, are those of a different reporting entity. A change in the reporting entity is limited mainly to presenting consolidated or combined financial statements in place of financial statements of individual entities, changing specific subsidiaries that make up the group of entities for which consolidated financial statements are presented, or changing the entities included in combined financial statements.

Error in Previously Issued Financial Statements

An error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in the application of generally accepted accounting principles (GAAP), or oversight or misuse of facts that existed at the time the financial statements were prepared. A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error.

Indirect Effects of a Change in Accounting Principle

Any changes to current or future cash flows of an entity that result from making a change in accounting principle that is applied retrospectively. An example of an indirect effect is a change in a nondiscretionary profit sharing or royalty payment that is based on a reported amount such as revenue or net income.

Restatement

The process of revising previously issued financial statements to reflect the correction of an error in those financial statements.

Retrospective Application

The application of a different accounting principle to one or more previously issued financial statements, or to the statement of financial position at the beginning of the current period, as if that principle had always been used, or a change to financial statements of prior accounting periods to present the financial statements of a new reporting entity as if it had existed in those prior years.

SOLUTIONS TO REVIEW QUESTIONS

1. **Each of the following situations is considered an example of an accounting change, except?**
   a. Change in reporting entity.
   Incorrect. A change in reporting entity is an example of an accounting change based on ASC 250. A change in reporting entity is primarily limited to presenting consolidated or combined financial statements in place of individual entities, changing specific subsidiaries that make up the group of entities for which consolidated financial statements are presented, and change the entities included in the combined financial statements.
   b. Change in accounting principle.
   Incorrect. A change in accounting principle is an example of an accounting change based on ASC 250. An example of a change in accounting principle includes, but is not limited to, an entity switching from the FIFO method of inventory valuation to the LIFO method, or vice versa. The key here is to note that the change in accounting principle is from one GAAP method to another GAAP method.
   c. Change in accounting estimate.
   Incorrect. A change in accounting estimate is an example of an accounting change based on ASC 250. An example of a change in accounting estimate is a change in the estimated useful life or salvage value of an entity's long-lived asset.
   d. Change in prior period financial statements.
   Correct. A change in an entity's prior period financial statements is considered a correction of an error. While this is not an accounting change by definition, the considerations with respect to error corrections are contemplated within ASC 250.

2. **Which of the following situations is an example of a change in accounting principle?**
   a. A change in an entity's method for valuing its inventory.
   Correct. A change in an entity's inventory valuation method, for example from FIFO to LIFO, would be an example of a change in an accounting principle. In addition, a change in an entity's date for its goodwill impairment testing would be another example of a change in accounting principle.
   b. A change in an entity's estimated warranty liability.
   Incorrect. A change in estimated liability for warranties is an example of a change in accounting estimate, not a change in accounting principle.
   c. A change in the estimated useful life of one of the entity's significant assets.
   Incorrect. A change in the estimated useful life of a long-lived asset is an example of a change in accounting estimate, not a change in accounting principle.
   d. A change in the estimate of excess and obsolete inventory.
   Incorrect. A change in the estimate of obsolete and excess inventory is an example of a change in accounting estimate, not a change in accounting principle.

3. **Which of the following identifies a required disclosure with respect to a material change in an accounting estimate?**
   a. The cumulative effect on comprehensive income.
   Incorrect. The cumulative effect on comprehensive is not a required disclosure for a change in accounting estimate. Instead, disclosing the cumulative effect on retained earnings, not comprehensive income, is a required disclosure for a change in accounting principle.
   b. The effects on any related per-share related amounts.
   Correct. The effects on any related per-share related amounts is a required disclosure for a material change in accounting estimate. In addition, an entity is required to disclose any changes on income from continuing operations as well as net income.
   c. The effects on prior period financial information.
   Incorrect. A description of the prior period information that has been retrospectively adjusted is not a required disclosure for a change in accounting estimate. Instead, this is a required disclosure for a change in accounting principle.
   d. The nature of and reasons for the change.
   Incorrect. The nature of and reasons for the change is not a required disclosure for a change in accounting estimate. Instead, this is a required disclosure for a change in accounting principle.

4. **Which of the following SAB topics provides guidance on correction of errors, including the correction o immaterial errors existing in prior period financial statements?**
   a. SAB 108.
   Correct. SAB 108 addresses quantifying the financial statement effects of errors (i.e., the quantitative analysis) and provides guidance on the correction of errors, including the correction of immaterial errors existing in prior period financial statements. In addition, this SAB topic addresses the use of both the iron curtain method and the rollover method.
   b. SAB 101.
   Incorrect. SAB 101 does not provide guidance on the correction of errors. Instead, this SAB topic addresses the SEC staff's views in applying GAAP to revenue recognition in financial statements.

Continued on next page

c. SAB 105.
Incorrect. SAB 105 does not provide guidance on the correction of errors. Instead, this SAB topic addresses the SEC staff's views in applying GAAP to loan commitments accounted for as derivative instruments.

d. SAB 115.
Incorrect. SAB 115 does not provide guidance on the correction of errors. Instead, this SAB topic rescinds portions of the interpretive guidance included in the codification of the Staff Accounting Bulletin Series in order to make the relevant interpretive guidance consistent with authoritative accounting guidance and Securities and Exchange Commission rules and regulations.

5. If an entity determines that a Big R Restatement is required, then the entity should file which of the following SEC forms in order to restate its annual report?

a. Form S-4.
Incorrect. Form S-4 would not be used to restate an entity's annual report. Instead, this form would be used to report a merger or acquisition between two companies.

b. Form 11-K.
Incorrect. Form 11-K would not be used to restate an entity's annual report. Instead, this form deals with employee stock purchases and savings plans with interests in securities registered under the Securities Act of 1933.

c. Form 10-K/A.
Correct. The Form 10-K/A is the form used to restate an entity's annual report. This is only the case when a Big R Restatement is necessary. For a Little R Restatement, the entity would not be required to amend its Form 10-K.

d. Form 10-Q/A.
Incorrect. Form 10-Q/A would not be used to restate an entity's annual report. Instead, this form would be used to restate an entity's quarterly report.

6. Which of the following errors may in fact be considered material even if it is quantitatively immaterial?

a. It results from a computational error.
Incorrect. An immaterial error that results from a mathematical or computational error would not necessarily be considered material on a qualitative basis. However, if the error identified has the effect of increasing management's compensation, this would be an example of when an immaterial error may be qualitatively rendered material.

b. It was identified by the entity's independent accountant.
Incorrect. An immaterial error identified by the entity's registered public accounting firm would not necessarily be considered material on a qualitative basis. However, if the error identified served to hide a failure to meet analysts' consensus expectations for the enterprise, this would be an example of when an immaterial error may be qualitatively rendered material.

c. It results from misapplication of a new ASU.
Incorrect. The misapplication of a new ASU, if it results in an immaterial error, would likely not be rendered material. Instead, an example of this situation would be if the error masks a change in earnings or other trends.

d. It involves concealment of an unlawful transaction.
Correct. While it may be determined that the error, quantitatively, is not material, if it involves the concealment of an unlawful transaction, it is likely that the error would be considered material. An additional example of when an immaterial error may in fact be rendered material would be the case if the error affected the entity's compliance with regulatory requirements.

ACCOUNTING CHANGES AND ERROR CORRECTIONS

(2 CE HOURS)

FINAL EXAM

1. **Which of the following FASB ASC topics prescribe requirements with respect to accounting changes and error corrections?**
   a. ASC Topic 210.
   b. ASC Topic 220.
   c. ASC Topic 250.
   d. ASC Topic 235.

2. **Which of the following types of accounting change generally requires prospective treatment?**
   a. Change in accounting estimates.
   b. Corrections of a material error.
   c. Change in accounting principle.
   d. Change in reporting entity.

3. **If an entity modifies its estimated allowance for loan losses, then this is an example of which of the following accounting changes?**
   a. Change in reporting entity.
   b. Correction of an error.
   c. Change in accounting principle.
   d. Change in accounting estimate.

4. **Which of the following identifies a requirement for an entity in order to change from one GAAP method to another GAAP method of accounting for certain transactions or events?**
   a. Disclose the anticipated change in a Form S-4.
   b. Request approval from the entity's independent accountant.
   c. Request a preferability letter from the PCAOB.
   d. Justify that the other GAAP method is preferable.

5. **Each of the following is required to be disclosed for a change in accounting principle, except?**
   a. The cumulative effect of the change on comprehensive income.
   b. The effect of the change on income from continuing operations
   c. A copy of the approval letter from the entity's independent accountant.
   d. A description of the prior-period financial statements that have been retrospectively adjusted.

6. **Which of the following methods for assessing an error correction quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the current year?**
   a. Iron curtain method.
   b. Retrospective method.
   c. Fair value method.
   d. Rollover method.

7. **Which of the following methods for assessing an error correction quantifies a misstatement based on the amount of the error originating in the current year income statement?**
   a. Iron curtain method.
   b. Prospective method.
   c. Rollover method.
   d. Income statement method.

8. **Which of the following types of restatements generally occurs when the effects on the prior period financial statements are not material?**
   a. Big R restatement.
   b. 10-K/A restatement.
   c. 10-Q/A restatement.
   d. Little R restatement.

9. **Which of the following SAB topics states that the assessment of the materiality of errors should consider both qualitative and quantitative considerations?**
   a. SAB 99.
   b. SAB 102.
   c. SAB 104.
   d. SAB 108.

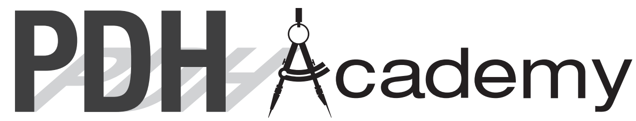
10. **When a public company, who is an SEC registrant, initiates a voluntary change in accounting principle on the basis that it is preferable, the entity is required to include a preferability letter issued by which of the following within its next periodic report?**
    a. The PCAOB.
    b. Its independent registered public accounting firm.
    c. The SEC's Office of the Chief Accountant.
    d. The Emerging Issues Task Force.

11. **Which of the following types of restatements generally occurs when the effects on the prior period financial statements are material?**
    a. Big R restatement.
    b. Little R restatement.
    c. Modified restatement.
    d. Cumulative restatement.

12. **If an entity concludes that retrospective application of a change in accounting principle is impractical, then an entity is required to do which of the following?**
    a. Request approval from the FASB to apply the change prospectively.
    b. Disclose the reasons why retrospective application is impractical.
    c. Continue accounting for the transaction using its existing method.
    d. Request that its auditor attest to the impracticability in their audit report.

13. **Which of the following ASUs primarily made amendments to the inventory guidance but also amended the master glossary definition of direct effects of a change in accounting principle?**
    a. ASU 2015-01.
    b. ASU 2014-09.
    c. ASU 2015-11.
    d. ASU 2016-01.

14. **Which of the following ASUs that eliminated the use of the term extraordinary item also made a conforming amendment to the disclosure guidance for changes in a reporting entity?**
    a. ASU 2015-11.
    b. ASU 2016-01.
    c. ASU 2016-02.
    d. ASU 2015-01.



Course Evaluation Form

Program Title: ______________________________

Program Date: ______________________________

Participant Name: ______________________________

Please indicate your agreement with the following statements:	Agree	Disagree	Don't Know
1. Stated Learning Objectives were met	______	______	______
2. Stated prerequisite requirements were appropriate and sufficient	______	______	______
3. Program materials were relevant and contributed to the achievement of the learning objectives	______	______	______
4. Time allotted to the learning activity was appropriate	______	______	______
5. If applicable, individual instructors were effective	______	______	______

Additional Comments:

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Thank you for your comments!