

SFAS 154, Accounting Changes and Error Corrections

In May 2005, the FASB adopted Statement of Financial Accounting Standards (SFAS) No. 154, *Accounting Changes and Error Corrections*, a replacement of APB Opinion No. 20, *Accounting Changes* and SFAS 3, *Reporting Accounting Changes in Interim Financial Statements*. Effective January 1, 2005, the IASB revised IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*. This update describes these changes and compares US and IAS GAAP treatment of accounting changes and error corrections.¹

Accounting Changes

Both SFAS 154 and IAS 8 mandate use of the retrospective method (application of the new method to all previously issued financial statements) for reporting:

- All voluntary changes in accounting principle²
- Changes mandated by accounting pronouncements that do not specify transition provisions, and
- Changes in the reporting entity (such as adding or removing subsidiaries from the consolidated group).

The retrospective method requires recognition of all changes in the balances of related assets and liabilities (direct effects) that result from a change in accounting principle. A corresponding adjustment must be recorded in the opening balance (of the earliest period restated) of retained earnings or other equity or net asset balance. Period-specific effects of applying the new accounting principle must be reported in the financial statements of each individual period presented.

SFAS 154 requires any indirect effects of a change in accounting principle (such as changes in current and future cash flows due to the effect of the accounting change on royalty or profit sharing payments) to be recognized, described, and

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The Third Edition discussion of these issues is located on pages 54 – 55.

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SFAS 154 states that a company may make a voluntary accounting change only when the alternative method is preferable to the method replaced. IAS 8 states that the change must result in “more relevant” information.

separately disclosed (total amount and related per-share amounts) in the period of the accounting change. IAS 8, however, does not address the accounting treatment of indirect effects.

Both standards provide an exception when it is impracticable to determine the period-specific effects of an accounting change on one or more individual prior periods presented. In such cases, the retrospective method must be applied as of the beginning of the earliest period practicable with a corresponding adjustment to the beginning balance of the retained earnings or other components of equity or net assets in the balance sheet.

The retrospective method must be applied on the earliest date practicable when it is impracticable to assess the cumulative effect of the change of the change in accounting principle on all prior periods. Illustration 2 in Appendix A of SFAS 154 contains a detailed example based on a change from the FIFO inventory valuation method to the LIFO method.

The use of the full retrospective method is considered impracticable only when all reasonable efforts have been exhausted or it is not possible to independently substantiate necessary assumptions about management's intent in a prior period. SFAS 154 requires disclosure of the reasons for using the impracticability exception and a description of the alternative method used to report the change. The impracticability exception is not available for prechange interim periods of the fiscal year in which the entity adopts a change. In those cases, the change can only be adopted as of the beginning of a subsequent fiscal year.

The most important benefit of the change to retrospective application will be enhanced interperiod comparability and consistency across periods. Unlike APB Opinion 20 and the old IAS 8, the cumulative effect of an accounting change will no longer be recognized in the income statement in the period of the change. The new method will permit an assessment of the impact of the change on prior periods and analysis of trends in profitability and other valuation relevant indices using data derived from consistently used accounting methods.

Disclosures Related to Accounting Changes

In addition to descriptive disclosures of the nature and rationale for the change, companies are required to disclose the method of applying the change as well as the effect of the change on income from continuing operations, net income, any affected line items, and any affected per share amounts for both the current and any prior periods that have been retrospectively adjusted.

Changes in Accounting Estimates

In a significant departure from APB 20 (where a change in depreciation method was treated as a change in accounting principle), SFAS 154 requires that changes in depreciation, amortization, or depletion methods for long-lived, nonfinancial assets must be accounted for as a change in accounting estimate due to a change in accounting principle. This change in U.S. GAAP mirrors the accounting treatment in IAS 8. Note that companies will have to demonstrate that a change in estimate stemming from a change in accounting principle is preferable (more relevant under IAS 8). Such changes must be accounted for prospectively, with no restatement of previously issued financial statements.

However the new standards improve the disclosure requirements for such changes.³ Companies must disclose the current period effects of the change (previously required) and any effect on future periods (not previously required).

This change mirrors the existing treatment of changes in functional currency (see text pages 574-5 for an example), which are not considered a change in accounting principle. We assume that these expanded disclosure requirements will apply to future changes in functional currency.

While the adoption of SFAS 123R requiring that companies expense the fair value of stock options (see separate Chapter 12 Update) is considered a mandatory accounting change, changes in valuation methods or the method of choosing assumptions will be considered changes in accounting assumptions requiring disclosure under SFAS 154.

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See text pages 268-272 for a discussion of the effects of changes in depreciation method, and the disclosures previously required.

Interim Period Accounting Changes

SFAS 154 requires that changes in accounting principles made in interim periods be reported using the retrospective method, including restatement of previously issued interim period statements. When it is “impractical” to restate prechange interim periods, the accounting change must be made at the beginning of the next fiscal year. Accounting changes made during the fourth fiscal quarter must be accompanied by disclosure of the effect on interim periods reported. IAS 34, Interim Financial Reporting, also requires retrospective restatement of prior interim reports for accounting changes.

Error Corrections

SFAS 154 limits the use of the “restatement” method to the correction of an error in previously issued financial statements and continues the requirements of APB Opinion 20 for reporting (1) the correction of an error and (2) a change in estimate (prospective recognition).

The requirement to restate for error corrections is mandatory in U.S. GAAP. However, IAS 8 permits retrospective restatement from the earliest period practicable when restatement is impracticable.

Disclosures Related to Error Corrections

For error corrections that affect several periods, the entity must provide a description of the error and disclose:

- 1 The effect on each line item and any per-share amount for each prior period affected
- 2 The cumulative effect as of the beginning of the earliest period restated

Effective Date and Transition

Companies will have to adopt SFAS 154 in fiscal years beginning after December 15, 2005. The revised IAS 8 applies to annual periods beginning on or after January 1, 2005. Early adoption is permitted by both standards.

Conclusion

The major benefits of the adoption of SFAS 154 and the revised IAS 8 are the

enhanced disclosures related to accounting changes. The standards also improve comparability in this area between companies applying US GAAP and those using IAS GAAP.