MODUL-7
Financial Accounting

Accounting Change, Accounting Policy & Error Analysis

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Accounting Change, Accounting Policy & Error Analysis

After studying this topic, students should be able to:

1. Understand the basic of Accounting Change & Error Analysis.
2. Identify and Differentiate Among the Type of Accounting Change.
3. Identify and explain alternative methods of accounting for accounting changes.
4. Identify the Accounting Standards for each Type of Change.
5. Apply the Retroactive Application Method of Accounting for an Accounting Change.
6. Identify the Disclosure Requirements for Changes in Accounting Policies and for Errors.
7. Apply the Prospective Application Method for an Accounting Change.
8. Identify the Disclosure Requirements for Changes in Accounting Estimates.
10. Analyse the Effects of Errors.
12. Understand The Summary of Change in Accounting Policy, Change in Accounting Estimate & Error Analysis.
Accounting Changes and Error Analysis

Accounting Changes
- Changes in accounting principle
- Changes in accounting estimate
- Reporting in reporting entity
- Correction of errors
- Summary
- Motivations for change of method

Error Analysis
- Balance sheet errors
- Income statement errors
- Balance sheet and income statement effects
- Comprehensive example
- Preparation of statements with error corrections
Types of Accounting Changes

Statement of Accounting Standard (SFAS) No. 154, Types of accounting changes:
1. Changes in Accounting Principle
2. Changes in Accounting Estimates
3. Changes in Reporting Entity
4. Errors in Financial Statements
Changes in Accounting Principles

- A change from one Generally Accepted Accounting Principle (GAAP) to another. Examples include:
  - Average cost to LIFO.
  - Completed-contract to percentage-of-completion.

- Does not result from the adoption of a new accounting principle: Previously immaterial & Events for first time
  "Adoption of a new principle in recognition of events that have occurred for the first time or that were previously immaterial is not an accounting change."

- A change to a GAAP (from an incorrect principle) = correction of an error.
Three approaches have been suggested for reporting changes in the accounts:

1. Currently.
2. Retrospectively.

“Financial Accounting Standard Board (FASB) requires use of the retrospective approach.”

(Rationale - Users can then better compare results from one period to the next).
Changes in Accounting Principles: Current Treatment / Reporting

- New method or estimate’s cumulative effect on the financial statements of the beginning of the period is calculated.
- Adjustment is reported in current year’s income statement.
Changes in Accounting Principles: Retroactive Treatment / Reporting

- **Cumulative effect** new determined.
- **Prior period Financial Statement** recast based on new.
- Cumulative effect for periods prior to presentation = adjusted to **beginning retained earnings**.
  - Leads to comparable & consistent Financial Statement.
- Impracticable to retrospectively apply principle change (i.e. FIFO to LIFO).
- Results in **restating** all affected prior years’ financial statements on a basis consistent with the newly adopted policy.
Changes in Accounting Principles: Retroactive Treatment / Reporting

- Prospective reporting at earliest practicable date:
  1. Effects of retro application not determinable.
  2. Requires assumptions re: management intent in prior periods.
  3. Significant estimates for prior period required and unable to objectively verify info needed to develop retro adjustment.

➢ Impracticable to retrospectively apply principle change (i.e. FIFO to LIFO).

- Disclose:
  1. Effect of change in operations for change period
  2. Reasons for omitting computations
  3. Pro forma amounts for PY should be explained
  4. Justification for change
Changes in Accounting Principles: Prospective Treatment / Reporting

- Previously reported results remain; no change is made.
- Opening balances are not adjusted and no attempt is made to correct or change past periods.
- New policy or estimate is adopted for current and future periods only and applied to balances existing at the date of the change.
Changes in Accounting Principles: Prospective Application

- Effects of changes in estimates are handled prospectively.
- No changes are made to previously reported results.
  - Changes in estimates are viewed as normal recurring corrections and adjustments.
- Effect of a change in estimate is accounted for by including it in net income or comprehensive income as appropriate in:
  - The period of change if the change affects that period only.
  - The period of change and future periods if the change affects both.
# Accounting Changes & Related Accounting Methods

<table>
<thead>
<tr>
<th>Type of Accounting Change</th>
<th>Accounting Method Applied</th>
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</thead>
<tbody>
<tr>
<td>Adoption of primary source of GAAP <em>(Change in Accounting Policy)</em></td>
<td>Apply method approved in transitional provisions section of the primary source; if none, then retroactively.</td>
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<tr>
<td>Other than a change made on adoption of a primary source <em>(Change in Accounting Policy)</em></td>
<td>Apply retroactively.</td>
</tr>
<tr>
<td>Changes in accounting estimates</td>
<td>Apply prospectively.</td>
</tr>
<tr>
<td>Errors</td>
<td>Apply retroactively.</td>
</tr>
</tbody>
</table>
Retroactive With Restatement

Requirements of this method include:

1. Retroactive application of the new method, including income tax effects.
2. Prior-period financial statements included for comparative purposes.
3. Description of the change and effect on current and prior period financial statements disclosed.
Retroactively restating prior years’ financial statements requires information that may be impractical to obtain on a cost-benefit basis.

Section 3461’s transitional provision allows for the retroactive-without-restatement method.

Only difference between retroactive adjustment with restatement and without restatement is in the financial statements for prior periods that would have been reported had the new policy been in effect originally.

Without restatement leaves the comparative financial statements as originally reported and presents the change’s cumulative effect as an adjustment to Retained Earnings.
Changes in Accounting Estimates

- Financial Statement (FS) require estimates are: future conditions & events
  - Lack of certainty.
  - Judgment required.

- Examples:
  2. Change in life of depreciable assets.
  3. Salvage values of assets.
Changes in Accounting Estimates

- **Prospective basis**
  - Considered normal recurring corrections & adjustments
- **Estimates later determined incorrect**
  - Change in estimates
- **Impossible to determine**
  - Principle vs. estimate = estimate
  - Error vs. estimate = estimate for “careful estimates”
    - Judgment required
- Future conditions and events and their effects cannot be known with certainty; therefore estimation requires exercise of judgement.
- Use of reasonable estimates is essential to the accounting process and does not undermine the reliability of financial statements.
Examples of items requiring estimates include:

- Uncollectible receivables
- Inventory obsolescence
- Useful lives and residual values of depreciable assets
- Periods benefited by deferred costs
- Liabilities for warranty costs and income taxes
- Asset retirement obligations
- Recoverable mineral reserves
Reporting a Change in Entity

- Financial statements **restated** for all prior periods presented
- Examples
  - Consolidated statements in lieu of individual FS
    - Changes in subsidiaries in a consolidated group
    - Change in method for accounting for subsidiaries & investments
Prior period adjustments
- Adjust beginning Retained Earning (RE) for earliest period presented.

Examples
- Change from an accounting principle that is not generally accepted to one that is accepted.
- Mathematical errors.
- Changes in estimates that were not prepared in good faith.
- Failure to properly accrue/defer expenses/revenues.
- Misapplication or omission of relevant facts.
When is a Change in Accounting Principle Appropriate?

- New principle **preferable** to existing accounting principle.
  - New principle should result in **improved financial reporting**
    - Not solely for income tax effect.

- Considered preferable if SFAS:
  - Creates new accounting principle, or
  - Expresses preference for a new principle, or
  - Rejects a specific accounting principle.
1. **Self interest (Bonus payments)**
   - Managers standards to maximize bonuses.
   - When bonuses attached to income, managers *may* select methods that maximize income.

2. **Political cost**
   - Less politically visible to avoid regulation.
   - Larger firms, larger profits, may become political targets; select policies to reduce profits.

3. **Capital structure**
   - High debt/equity.
   - Debt/equity structure will impact accounting policies due to debt covenants.

4. **Smooth earnings**
   - To avoid notice (regulators, competitors, etc.)
   - Gradual increase (decrease) in income to shift attention.
Firms do not correct errors that are insignificant

Considerations
- What type of error is involved?
- What correcting entries are needed?
- How are financial statements to be restated?

Reported as Property, Plant & Equipments (PPEs)
Entries to correct differ:

- If books are closed (all past revenues and expenses have been transferred to retained earnings).
- If books are still open (amounts of revenue and expense are still in their respective accounts).

Need to correct them where they are!

**Approach to analysis:**

1. Develop a clear picture of what **is** in the accounts now (before correcting)
2. Develop a clear picture of what **should be** in the accounts now (after correcting or if done correctly from the start)
3. Debit and credit accounts to bring (1) to (2).
Types of Errors

- Balance sheet Error
  - Classifications

- Income statement Error
  - Classifications

- Balance sheet & income statement Errors

- Types – a *must know* for entry level positions
  - Counterbalancing (or self-correcting over two accounting periods)
    - Accrued payroll
  - Non-counterbalancing (more than two periods needed)
    - Expense vs. capitalization
Balance Sheet Errors

- Affect only the presentation of an asset, liability or shareholders’ equity account.
  - e.g. classifying short-term receivable as long-term.
- Reclassify when error is discovered.
- If comparatives, balance sheet for error year is restated correctly.
- No further corrections required.
Income Statement Errors

- Affect only the presentation of nominal accounts in the income statement.
  - Involve improper classification of revenues or expenses
- No effect on balance sheet or net income.
- Reclassification entry required if discovered in the year it is made.
- If comparatives, restate error year.
Balance Sheet & Income Statement Errors

- Involve both balance sheet and income statement
  - e.g. accrued wages payable was overlooked at year end
- **Counterbalancing Error** (self-correcting over two periods).
- **Noncounterbalancing Error** (takes more than two periods to self-correct).
Counterbalancing Errors

- Questions to be considered are:
  - Are the books closed?
  - Are comparative statements presented?
- Adjust beginning Retained Earning (RE)
  - Books are closed & error is not counterbalanced, or
  - Books are not closed & company is in the second year & error is already counterbalanced
Examples of accounting errors include:

- Change from non-GAAP to GAAP
  - e.g. change from cash basis of accounting to accrual basis
- Mathematical mistakes
  - e.g. incorrect totaling of inventory count sheets
- Oversight
  - e.g. failure to defer expenses or revenues
- Misappropriation of assets
  - e.g. discovery of inventory theft
Changing From and To the Equity Method

- Requires restatement of all prior period Financial Statement (FS)

- From equity method to Fair Value (FV) method must be made when:
  - Investor’s level of influence falls below required percentage of ownership

- A change from fair value method to the equity method must be made when:
  - Investor’s level of influence rises above required ownership %
Changing To the Equity Method

Retroactive adjustments/reporting

- Carrying value of investment
- Results of current & prior period operations
- Retained earnings of investor
- Any balances in unrealized holding gains & losses are eliminated
- Available-for-sale classification also removed
For changes in policy resulting from applying the transitional provisions of a primary source of GAAP:

a). Amount of adjustment for current period and each prior period presented, including the effect of the change on each financial statement line item and the per share amounts affected;

b). Amount of the adjustment related to periods prior to those presented as comparative;

c). Either that the change has been applied retroactively to the comparative information, or without restatement and an explanation why this was impractical;
(d) If the change may have an effect in future periods, a description of the provisions affecting future periods.

- For **voluntary changes in accounting policy** that affect current or prior periods presented, or may have an effect in future periods:
  - Items (a) to (c) are required;
  - Explanation of the change and justification why the new policy provides a more relevant presentation of the entity’s financial position, financial performance or cash flows.
Disclosures – Changes in Accounting Policy & Error Correction

- For a change in a primary source of GAAP that has been issued but is not yet effective:
  1. Its required effective date of adoption;
  2. The date it is expected to be adopted;
  3. Either an estimate of its effect on the company’s financial position, financial performance or cash flows, or a statement to the effect that such an estimate cannot be made without undue cost or effort.
Where a change is the result of an accounting error, companies must disclose that an error occurred in a prior period(s) and report, at minimum:

1. The nature of the error;
2. The amount of the correction for each prior period presented, and the amount related to periods prior to those presented;
3. That comparative information has been restated.
PSAK No. 25 (Revisi 2009) : Kebijakan Akuntansi, Perubahan Estimasi Akuntansi dan Kesalahan

- **Ruang Lingkup :**
  - Pernyataan ini diterapkan dalam pemilihan dan penerapan kebijakan akuntansi, serta pencatatan perubahan kebijakan akuntansi, perubahan estimasi akuntansi, dan koreksi kesalahan periode lalu.
  - Dampak pajak dari koreksi kesalahan periode lalu dan penyesuaian retrospektif untuk perubahan kebijakan akuntansi diperlakukan dan diungkapkan sesuai dengan **PSAK 46 : Akuntansi Pajak Penghasilan.**

- **Tanggal Efektif :**
  Entitas menerapkan Pernyataan ini untuk periode tahun buku yang dimulai pada atau setelah tanggal **1 Januari 2011.**

- **Penarikan :**
  Pernyataan ini menggantikan **PSAK 25 (1994) : Laba atau Rugi Bersih untuk periode Berjalan, Kesalahan Mendasar, dan Perubahan Kebijakan Akuntansi.**
PSAK No. 25 (Revisi 2009) : Kebijakan Akuntansi, Perubahan Estimasi Akuntansi dan Kesalahan

1. Kebijakan Akuntansi :
   - Pemilihan dan Penerapan Kebijakan Akuntansi.
   - Konsistensi Kebijakan Akuntansi.
   - Perubahan Kebijakan Akuntansi :
     b. Penerapan Restrospektif.
     c. Keterbatasan Penerapan Restrospektif.
     d. Pengungkapan.

2. Perubahan Estimasi Akuntansi
   - Pengungkapan.

3. Kesalahan
   - Keterbatasan Penyajian Kembali Restrospektif.
   - Pengungkapan Kesalahan Periode Lalu.

Perbedaan PSAK No. 25 (Revisi 2009) dengan International Financial Reporting Standard (IFRS)


1. IAS 8 Paragraf 05 yang menjadi PSAK 25 Paragraf 07 tentang Definisi Standar Akuntansi Keuangan dengan adanya tambahan peraturan regulator Pasar Modal, sesuai definisi yang digunakan di PSAK 1 (Revisi 2009) : Penyajian Laporan Keuangan.

2. IAS 8 Paragraf 54 yang menjadi PSAK 25 Paragraf 54 tentang Tanggal Efektif.
Changes in Accounting Policy: The Summary

**General Rule 1:**

- On adoption of a primary source of GAAP, apply the related transitional provisions.
- If none, apply retroactively the following **Rule 2.**

**General Rule 2:**

- For a voluntary change in policy, use retroactive-with-restatement approach:
  1. Report current and future results on new basis.
  2. Restate all prior period financial statements presented for comparison.
  3. Adjust the opening balance of retained earnings for the earliest period presented.
  4. Provide note disclosures that enable users to understand effects of the policy change.
  5. Apply the effect of the change to all applicable amounts in historical summaries of financial data provided.
Changes in Accounting Policy: The Summary

Exceptions:

If restatement of comparative information is impractical, use retroactive-without-restatement method:

1. Apply the new policy to as many prior comparative periods as possible.
2. For periods where impractical, apply new policy to assets and liabilities at beginning of next accounting period.
3. For the periods reported where application is impractical, adjust opening retained earnings balance of the next accounting period.
4. Provide note disclosures for users to understand effects.
5. Applying the effect of the change to all applicable amounts in historical summaries of financial data provided to extent possible.
Changes in Accounting Estimates: The Summary

Use **Prospective approach** by:

1. Reporting current and future results on the new basis.
2. Presenting prior period financial statements as previously reported.
3. Making no adjustment to current period opening balances and no catch-up provisions.
4. Providing note disclosures for users to understand the effects.
Use **retroactive-with-restatement approach** by:

1. Restating all prior period financial statements presented for comparison as if error had never occurred.

2. Adjusting the opening balance of retained earnings for the earliest period presented.

3. Providing note disclosures for users.

4. Applying the effect of the error to all applicable amounts in any historical summaries of the financial data provided.
REFERENCES

1. American Institute of Certified Public Accountants (AICPA), http://www.aicpa.org
4. Indonesian Institute of Accountants (IIA), Dewan Standard Akuntansi Keuangan (DSAK), http://www.iaiglobal.or.id