

Reporting Accounting Changes

Companies will have to apply voluntary changes in accounting principle retrospectively whenever it is practicable, a determination expected to be difficult in many circumstances, under the requirements in FASB Statement 154.¹ The requirements are effective for accounting changes made in fiscal years beginning after December 15, 2005.

Changes in Accounting Principle

Statement 154 requires retrospective application for voluntary changes in accounting principle unless it is impracticable to do so. Retrospective application refers to the application of a different accounting principle to previously issued financial statements as if that principle had always been used. Statement 154's retrospective-application requirement replaces APB 20's requirement to recognize most voluntary changes in accounting principle by including in net income of the period of the change the cumulative effect of changing to the new accounting principle.²

If the cumulative effect of the change in accounting principle can be determined, but it is impracticable to determine the specific effects of an accounting change on one or more prior periods presented, the change in accounting policy will have to be applied to the balances of assets and liabilities as of the beginning of the earliest period for which retrospective application is practicable, with a corresponding adjustment made to the opening balance of retained earnings or other components of equity (e.g., accumulated other comprehensive income) for that period. If it is impracticable to determine the cumulative effect of applying a change in accounting principle, the new accounting principle is to be applied prospectively from the earliest date practicable. If retrospective application for all prior periods is impracticable, the method used to report the change and the reason that retrospective application is impracticable are to be disclosed.

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¹ FASB Statement No. 154, Accounting Changes and Error Corrections: a replacement of APB Opinion No. 20 and FASB Statement No. 3, May 2005.

² APB Opinion No. 20, Accounting Changes, July 1971.

Determining Impracticability

Retrospective application is considered impracticable if its effects cannot be determined or if it would necessitate either of the following:

- Assumptions about management's intent in a prior period that cannot be independently substantiated.
- Significant estimates as of a prior period if it is impossible to objectively determine information about those estimates that provides evidence of the circumstances at that time and would have been available when the financial statements for that period were issued.

Applying these criteria can call for difficult judgments. Moreover, an entity must make "every reasonable effort" to apply retrospective application before concluding that the effects cannot be determined.

"Indirect Effects" of Retrospective Application

If retrospectively applying a voluntary change in accounting principle alters current or future cash flows, the effect is to be recorded only in the period of the voluntary change. These events, called "indirect effects" of retrospective application, could be caused by the interaction between the change in accounting principle and contractual obligations. Indirect effects should be excluded from the retrospective adjustment to the prior-period amounts.

For example, assume a company has a plan that requires it to make profit-sharing payments based on a percentage of net income. Retrospectively applying a voluntary change

in accounting principle increases net income and therefore what would have been paid in prior years. The plan requires the company to pay the incremental amount that would have been paid. In this situation, the company would accrue an expense for the indirect effect in the period of the voluntary change, not report it as an adjustment to the prior-period financial statements. The notes to the financial statements would disclose the amount of any indirect effects recorded in the period of the change, specifying the portion attributable to each prior period presented if it is practicable to determine the amounts. If the plan had not required the company to pay the incremental amount, but the company nevertheless decided to pay it, the accounting and disclosures would be the same.

Application of New Pronouncements

Under Statement 154, retrospective application will be the transition method in the unusual instance that a newly-issued accounting pronouncement does not provide specific transition guidance. It is expected that many pronouncements will specify transition methods other than retrospective.

Change in Depreciation Method

The new Statement requires that a change in depreciation method be accounted for as a change in estimate, not as a change in accounting principle as previously required by APB 20. However, because a principle is involved, a change in depreciation method is considered a change in estimate "inseparable" from a change in principle and must be justified by its preferability. Thus, a change from an accelerated method of depreciation to the

straight-line method would be accounted for the same way as a change in estimated useful life or salvage value, but disclosure justifying the preferability of the change would be required.

Disclosures of Restatements

Statement 154 distinguishes between retrospective application for changes in accounting principle and restatement for correction of an error. According to the FASB, restatement refers to "the process of revising previously issued financial statements to reflect the correction of an error in those financial statements." If financial statements are restated to correct an error, the nature of the error must be disclosed. The following disclosures are also required at the time of restatement:

- The effect of the correction on each financial-statement line item and any per-share amounts affected for the current period and all prior periods presented,
- The cumulative effect of the restatement on retained earnings or other components of equity as of the beginning of the earliest period presented, and
- A statement that previously issued information has been restated.

Companies will need to carefully disclose the reason for the restatement, because the new requirements are likely to increase the number of retrospectively-applied accounting changes. Restatement for an error correction can deliver a message significantly different from the message delivered by a retrospectively-applied change in accounting principle.



Guidance Carried Forward

Statement 154 carries forward APB 20's guidance on reporting these matters:

- Correction of an error in previously issued financial statements accounted for by restating the prior-period financial statements,
- A change in accounting estimate accounted for prospectively,
- A change in the reporting entity accounted for retrospectively, and
- The justification for changing an accounting principle on the grounds that it is preferable.

The new pronouncement also carries forward Statement 3's requirements on accounting for changes in accounting principles in interim periods.³ If an entity makes an accounting change in an interim period other than the first, Statement 154 precludes it from asserting that it is unable to retrospectively apply the change to the beginning of that annual period.

The descriptive and summary statements above are not intended to substitute for the text of Statement 154 and are not necessarily applicable to any company's particular circumstances. Companies applying Statement 154 should consult its text and their accounting and legal advisors.

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³ FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements, December 1974.