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Tackling Accounting Changes and Errors

A review of ASC 250 for preparing financial statements

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The credibility of financial markets rests on the foundation of high quality financial reporting. An important pillar of high quality public financial reporting is reliable, comparable financial statements that are free from material misstatement. Accounting changes and errors in previously filed financial statements can affect the comparability of financial statements.

This article provides an overview of the types of accounting changes that affect financial statements, as well as the disclosure and reporting considerations for error corrections. Also, implementation of any aspect of U.S. GAAP has control considerations that need to be addressed, especially regarding error corrections.

ACCOUNTING CHANGES

The Financial Accounting Standards Board's (FASB) Accounting Standards Codification (ASC) Topic 250, *Accounting Changes and Error Corrections* (ASC 250), addresses certain circumstances that require special accounting or disclosure, including:

- Change in Accounting Principle;
- Change in Accounting Estimates;
- Change in Reporting Entity; and
- Correction of an Error in Previously Issued Financial Statements.

Accounting changes are those in the first three categories above. In order to understand the accounting and disclosure obligations for each of these categories, it is helpful to begin with a basic understanding of their meaning.

CHANGE IN ACCOUNTING PRINCIPLE

A change in accounting principle is defined by ASC 250 as: *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.*

A change in accounting principle is applied for two types of changes:

1. Mandatory changes required by a newly issued Accounting Standard Update (ASU); or
2. Voluntarily changes from one acceptable accounting principle to another on the basis that it is preferable.

Newly issued ASUs include specific transition and disclosure guidance for the period of adoption. Voluntary changes in accounting principles should be applied retroactively to the beginning of the earliest period presented in the financial statements (i.e., so that the comparative financial statements reflect the application of the principle as if it had always been used), unless it is impracticable to do so. If retrospective application is impractical, the change should be adopted as of the beginning of a fiscal year. Whether it is impracticable to apply a new principle on a retrospective basis requires a considerable level of judgment.

ASC 250 presumes that an entity will apply accounting principles consistently unless new ASUs are issued. Voluntary changes from one acceptable method to another requires the reporting entity to prepare a profitability analysis to justify that the newly adopted acceptable accounting method is an improvement in financial reporting and the most preferable method for the reporting entity. The preferability analysis required to justify a change from one generally accepted accounting principle to another generally accepted principle also requires a considerable level of judgment and coordination with an entity's independent accountant. An SEC registrant is required to file a preferability letter from its independent accountant concurring with its conclusion that such a change was preferable.

Some reasons for voluntarily changing from one acceptable accounting principle to another are:

- **Improvement in Accounting Accuracy**: A company might change its accounting principle if the new method provides a more accurate representation of financial transactions and events. This could result in more reliable financial statements and a better reflection of the economic reality of the business.
- **Industry Practice**: Changes in accounting principles are made to align with industry practices or to ensure consistency with how peers in the same industry report their financial results. This justification can enhance comparability for investors and analysts.
- **Change in Business Model**: A significant change in a company's business model may require a corresponding change in accounting principle to appropriately account for new types of transactions or revenue streams.
- **Better Reflecting Economic Substance**: If a company shifts from using historical cost to fair value accounting for certain assets, it might do so to better capture their market values.
- **Consolidation or Merger**: In cases of mergers or business combinations, the acquiring company may impose its accounting principles on the acquired entity, leading to a change in accounting principle.

Keep in mind that an entity cannot freely change accounting principles simply to receive a more favorable accounting result. A voluntary change may only result from a change from an acceptable accounting method to a different acceptable accounting method that is considered 'preferable' meaning that the allowable alternative accounting principle is justified by enhancing the utility of financial statements for users.

Finally, it is important to distinguish the treatment from a change in accounting principle, as defined above, from a change that results from moving from an accounting principle that is not generally accepted to one that is generally accepted. This type of change is an error correction.

Disclosures

An entity is required to disclose:

1. The nature of and reason for the change in accounting principle, including a discussion of why the new principle is preferable. The method of applying the change,
2. The impact of the change to affected financial statement line items (including income from continuing operations and earning per share), and

3. The cumulative effect to opening retained earnings (if applicable)
4. Additional disclosures are required for any indirect effects of the change in accounting principle.

Financial statements of subsequent periods are not required to repeat these disclosures. If the change in accounting principle does not have a material effect in the period of change, but is expected to in future periods, any financial statements that include the period of change should disclose the nature of and reasons for the change in accounting principle.

CHANGE IN ACCOUNTING ESTIMATE

In accordance with ASC 250, 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. 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*.

Sometimes, a change in estimate is affected by a change in accounting principle (e.g., a change in the depreciation method for equipment). A change of this nature may only be made if the change in accounting principle is preferable.

A critical element of analyzing whether a change should be accounted for as a change in estimate relates to the nature and timing of the information that is driving the change. Companies should carefully assess whether such information is truly 'new' information identified in the reporting period or corrects inappropriate assumptions or estimates in prior periods (which would be evaluated as an error correction). For example, a change made to the allowance for uncollectible receivables to include data that was accidentally omitted from the original estimate or to correct a mathematical error or formula represents an error correction. Conversely, a change made to the same allowance to incorporate updated economic data (e.g., unemployment figures) and the impact it could have on the customer population would represent a change in estimate.

Disclosures

If the change in estimate is made in the ordinary course of accounting for items such as uncollectible accounts or inventory obsolescence, disclosure is not required unless the effect is material. If the change in estimate does not have a material effect in the period of change, but is expected to in future periods, any financial statements that include the period of change should disclose a description of the change in estimate.

CHANGE IN THE REPORTING ENTITY

In accordance with ASC 250, a change in reporting entity is: *A change that results in financial statements that, in effect, are those of a different reporting entity*.

A change in reporting entity is rare and generally limited to the following types of changes:
- 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; and

- Changing the entities included in combined financial statements.

Changes in the reporting entity mainly transpire from significant restructuring activities and transactions. Neither business combinations accounted for by the acquisition method nor the consolidation of a variable interest entity (VIE) are considered changes in the reporting entity.

Disclosures

For financial statements of periods in which there has been a change in reporting entity, an entity should disclose the nature of and reasons for the change. In addition, the effect of the change on income from continuing operations, 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. If the change in reporting entity does not have a material effect in the period of change, but is expected to in future periods, any financial statements that include the period of change should disclose the nature of and reasons for the change in reporting entity.

ERROR IN PREVIOUSLY ISSUED FINANCIAL STATEMENTS (ERROR CORRECTIONS)

Unlike 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. These three steps are fundamental in assessing accounting and financial statement errors:

Step 1 – Identify an Error

Accounting changes should be distinguished from error corrections. An error in previously issued financial statements as defined by ASC 250 is: *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*.

Accordingly, a change in an accounting policy from one that is not generally accepted by GAAP to one that is generally accepted by GAAP is considered an error correction[1], not a change in accounting principle. Likewise, if information is misinterpreted or old data is used when more current information is available in developing an estimate, an error exists, not a change in estimate. Moreover, as it relates to the classification and presentation of account balances on the face of the financial statements, many confuse errors with ‘reclassifications.’ Changing the classification of an account balance from an incorrect presentation to the correct presentation is considered an error correction, not a reclassification.

Step 2 – Assess Materiality of Error

Once an error is identified, the accounting and reporting conclusions will depend on the materiality of the error(s) to the financial statements. In connection with decisions related to the interpretation of federal securities laws, the U.S. Supreme Court has concluded that an item is considered material “if there is a substantial likelihood that a reasonable shareholder would consider it important” in making an investment decision or if it “would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available” to the shareholder.[2]

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[1] Except when a newly adopted ASU mandates such a change.
[2] TSC Industries v. Northway, 426 U.S. 438, 449 (1976).

While assessing the materiality of an error is not the subject of this article, companies (particularly SEC registrants) are directed to consider both the quantitative and qualitative considerations outlined in the extensive materiality guidance set forth in SEC Staff Accounting Bulletin (SAB) Topics 1.M and 1.N (formerly referred to as SAB Nos. 99 and 108, respectively). The SEC staff is especially focused on registrants' evaluation of materiality when assessing errors in previously issued financial statements. The staff has publicly emphasized the need for registrants to carefully and objectively consider all relevant facts and circumstances, both quantitative and qualitative, when evaluating errors. In certain cases, it may be difficult to overcome the materiality of a quantitatively large error with qualitative factors. Arguments that the SEC staff has not found persuasive when evaluating the materiality of errors include those that specify:

- The passage of time is relevant to the assessment due to the availability of more recent financial statements;
- Certain elements of GAAP or IFRS do not provide useful information to investors;
- Historical financial statements or specific line items in the financial statements are not relevant to investors' current investment decisions;
- A similar error was made by other registrants, and therefore, reflects a widely held view rather than an intention to misstate; or
- An individual error isn't material because the effect is offset by other errors.

Step 3 – Report Correction of Error

Reporting the correction of the error(s) depends on the materiality of the error(s) to both the current period and prior period financial statements. The error is corrected through one of the following three methods:

- **Out-of-period adjustment** – An error is corrected within the current period as an out-of-period adjustment when it is considered to be clearly immaterial to both the current and prior period(s). Disclosures are generally not required for immaterial out-of-period adjustments. However, there may be circumstances in which the out-of-period adjustment stands out (e.g., it appears as a reconciling item in the rollforward of an account balance) that may warrant consideration of disclosure about the item's nature.
- **'Little r Restatement'** – An error is corrected through a 'Little r restatement' (also referred to as a revision restatement) when the error is immaterial to the prior period financial statements; however, correcting the error in the current period would materially misstate the current period financial statements (e.g., this often occurs as a result of an immaterial error that has been uncorrected for multiple periods and has aggregated to a material number within the current year). Under this approach, the entity would correct the error in the current year comparative financial statements by adjusting the prior period information and adding disclosure of the error.
- **'Big R Restatement'** – An error is corrected through a 'Big R restatement' (also referred to as re-issuance restatements) when the error is material to the prior period financial statements. A Big R restatement requires the entity to restate and reissue its previously issued financial statements to reflect the correction of the error in those financial statements. Correcting the prior period financial statements through a Big R restatement is referred to as a 'restatement' of prior period financial statements.

Little r Restatements

Communication

As the prior period financial statements are not determined to be materially misstated, the entity is not required to notify users that they can no longer rely on the prior period financial statements.

Reporting Approach
Previously issued Form 10-Ks and 10-Qs are not amended for Little r restatements (as the financial statements included therein may continue to be relied upon). Under this approach, the entity would correct the error in the current year comparative financial statements by adjusting the prior period information and adding disclosure of the error.

Disclosures
Correcting the prior period financial statements through a Little r restatement is referred to as an 'adjustment' or 'revision' of prior period financial statements. As previously reported financial information has changed, we believe clear and transparent disclosure about the nature and impact on the financial statements should be included within the financial statement footnotes. As the effect of the error corrections on the prior periods is by definition, immaterial, column headings are not required to be labeled. Moreover, the auditor's opinion is generally not revised to include an explanatory paragraph in a Little r restatement scenario.

Big R Restatements

Communication
When a Big R restatement is appropriate, the previously issued financial statements cannot be relied upon. Therefore, the entity is obligated to notify users that those financial statements and the related auditor's report can no longer be relied upon. For an SEC registrant, this is accomplished by filing an Item 4.02 Form 8-K - *Non-reliance on previously issued financial statements or a related audit report or completed interim review* within 4 business days of the determination by the entity or its auditor that a Big R restatement is necessary[3].

Reporting Approach
Big R restatements require the entity to restate previously issued prior period financial statements. An SEC registrant will generally correct the error(s) in such statements by amending its Annual Report on Form 10-K and Quarterly Reports on Form 10-Q (i.e., filing a Form 10-K/A and Form 10-Q/As for the relevant periods).

When the errors' effect on the financial statements cannot be determined without a prolonged investigation (or the preparation of and auditing of the restated financial statements will simply take a longer period of time due to the nature of the errors), the issuance of the restated financial statements and auditor's report will necessarily be delayed. In some cases, the process may cause an SEC registrant to fall behind on its periodic reports. Questions often arise about the filing approach in this situation, particularly whether each 'missing' periodic report should be filed, or a comprehensive report on Form 10-K can be filed (i.e., a Super Form 10-K). In these situations, management should work closely with its securities counsel and auditors and may need to discuss its approach with the SEC staff, stock exchanges, or other regulatory agencies about the measures to be taken given the facts and circumstances.

Disclosures
ASC 250 includes several presentation and disclosure requirements when financial statements are restated for error corrections. Each financial statement period, column, and key footnote disclosures that are restated should be clearly labeled "as restated". The entity shall disclose:

- that its previously issued financial statements have been restated;
- a description of the nature of the error;

[3] It is important to note that the 8-K is required to be filed within 4 days of the determination that a restatement is necessary, not the filing of the restated financial statements. The filing of the restated financial statements may be weeks or even months after the 8-K is filed.

- the effect of the correction on each financial statement line item and any per-share amounts affected for each prior period presented, and;
- the cumulative effect of the correction 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.

Disclosures also typically include other details about the cause of the error, how it was discovered, and other direct and indirect impacts of the error. SEC registrants will also need to consider the impact of and/or disclosure of the error corrections within other sections of their filings (e.g., Supplementary Financial Information and Management's Discussion and Analysis). SEC registrants that do not qualify as smaller reporting companies are required to provide summarized quarterly financial information when there are one or more material retrospective changes (which would include material errors) to the statement of operations for any of the quarters within the two most recent fiscal years or any subsequent interim period for which financial statements are required to be included in the filing.

When correcting the error that has been determined to require a Big R restatement, an explanatory paragraph will be included within the auditor's report with a statement that the previously issued financial statements have been restated for the correction of a material misstatement in the respective period and a reference to the footnote disclosure of the correction of the material misstatement. Additionally, an entity will need to consider the impact of such errors on its internal control over financial reporting.

RECLASSIFICATIONS

Changes in the classification of financial statement line items in previously issued financial statements generally do not require restatements, unless the change represents the correction of an error (i.e., a misapplication of GAAP in the prior period). Reclassifications represent changes from one acceptable presentation under GAAP to another acceptable presentation. In financial statements which reflect both error corrections and reclassifications, clear and transparent disclosure about the nature of each should be included.

INTERNAL CONTROLS OVER FINANCIAL REPORTING (ICFR)

While ASC 250 does not explicitly address ICFR, ASC 250 has significant consequences to the 'presentation and disclosure' financial statement assertion. Entity-level controls are particularly important regarding control environment, especially board oversight, a commitment to competent control owners, and holding individuals accountable for their control responsibilities.

Once the entity has identified an error, whether material or immaterial, the entity should consider whether and how the identified error affects the design and effectiveness of the entity's related internal controls. An evaluation of internal controls is necessary even if the error does not result in a restatement or adjustment to prior period financial statements, as an error indicates that some aspect of the internal control design or execution was not properly functioning (i.e., a control deficiency). If it is determined that a control deficiency exists, management should evaluate whether it represents a deficiency, significant deficiency, or material weakness. In doing so, management should consider the existence of mitigating controls and as highlighted in the SEC's interpretive release, whether those controls operate at a level of precision that would prevent or detect a misstatement that could be material.

When a Big R restatement is required, the presence of the material misstatement in previously issued financial statements will almost always result in the identification of a material weakness.

When an out-of-period adjustment or Little r restatement is identified, the evaluation of what 'could be material' is relevant to the assessment of whether the mitigating control operates at a level of precision that would prevent or detect a material misstatement.

Pursuant to Regulation S-K, an SEC registrant should also consider:

- S-K Item 307 - whether disclosures provided in previously filed Forms 10-K and 10-Q need to be modified to explain whether previous conclusions regarding the effectiveness of disclosure and control procedures continue to be appropriate.
- S-K Item 308(a) - whether to revise its original report on the effectiveness of ICFR in a previously filed Form 10-K (i.e., whether the original disclosures in management's report continue to be appropriate).
- S-K Item 308(c) - whether to report a change in ICFR that was not previously identified in Forms 10-K and 10-Q. This reporting requirement could apply if there was a change in controls in the applicable fiscal quarter (fourth quarter for Form 10-K) that has materially affected, or is reasonably likely to materially affect, the entity's internal control over financial reporting.

Audit standards also require the auditor to assess the impact of identified errors on any previously issued opinions on a registrant's ICFR, which may require the reissuance of the opinion in certain circumstances.

CONCLUSION

Keep in mind that this article is simply a high-level overview of ASC 250. Preparers and auditors will need to carefully read the relevant aspects of it to fully understand and apply this important piece of U.S. GAAP. This will necessitate adequate ICFR, especially for the financial statement assertion of 'presentation and disclosure.'

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