

SOME ASPECTS REGARDING CHANGES IN ACCOUNTING POLICIES, ESTIMATES AND CORRECTION OF ERRORS

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Abstract: Changes in accounting policies may be precipitated by a change in the company's economic environment. Accounting changes may also result from changes in ownership that cause a shift in the financial reporting objectives, such as from private to public ownership, or vice versa. At each statement date, whether annual or quarterly, management must re-evaluate the many estimates that are required when financial statements are prepared. Changes in estimates may have a significant impact on reported results. Finally, there are necessary accounting changes that arise when a company discovers that it has made an *accounting error* in previous accounting periods. Obviously, errors need to be corrected in order to present fairly the financial condition and results of operations of the prior periods, even if the current period is not affected. Consistency and comparability must be achieved by correcting any errors that have a material effect on previously reported results. All types of accounting changes affect reported results, but not necessarily in the same way. The objective of our study is to describe the different types of accounting changes, the ways in which they affect reported results, and the accounting approach used to adjust for the changes.

1. Conceptual delimitations

Accounting policies are principles, bases, conventions, rules and practices adopted by an enterprise in preparing and presenting financial statements.

A change in accounting estimate is an adjustment of the accounting value of an asset or a liability or of the value of the periodical consumption of an asset which results from the evaluation of the current standard and the future benefits expected from it, and of an obligation associated to such an element (IAS 8).

Change in accounting estimate result from new information or new developments and, accordingly, are not corrections of errors.

Impracticable Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. For a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if:

(a) the effects of the retrospective application or retrospective restatement are not determinable;

(b) the retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period; or

(c) the retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:

(i) provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosed; and

(ii) would have been available when the financial statements for that prior period were authorised for issue from other information.

The retrospective method consists in the implementation of an adjustment on the financial statements as if it had been implemented from the beginning [Feleagă L., 2005].

Retrospective restatement is correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred.

The prospective method consists in the implementation of an adjustment on the financial statements, starting from the date when this adjustment is taken into account.

The errors of the prior financial year are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

(a) was available when financial statements for those periods were authorised for issue; and

(b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Such errors include mathematical mistakes, errors in implementing accounting policies, negligence in processing, deficient interpretations of the facts and frauds. [Malciu L., 2005].

2. Accounting Processing

IAS 8 standard deals with three important problems of the accounting processing, that is the cases of: changes in accounting policies, changes in accounting estimates and corrections of accounting errors which are summarized in the table

2.1 Changes in accounting policies

Users need to be able to compare the financial statements of an enterprise over a certain period of time to identify trends in its financial position, performance and cash flows implied by different activities. Therefore, the enterprise must use the same accounting policies which are normally adopted in each financial year, coping with the principle of method permanence.

A change in accounting policy should be made only if required by statute or by an accounting standard setting body, or if the change results in a more appropriate presentation of events or transactions included in the financial statements of the enterprise.

If an enterprise makes a change in accounting policies which results either from the implementation of a standard which does not include transitory stipulations, or from the enterprise's decision, the change should be implemented retrospectively.

The retrospective implementation requires that the entity should adjust the opening balance of each affected capital component for the oldest period presented, as if the new method had been always implemented. However, a change in accounting policy shall be applied retrospectively except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the change.

Example 1

Enterprise X is erecting a building for its own needs. The interest of the relative borrowings for this construction have been capitalised until present. During financial year N, the managers decided to change the accounting policies and to account the

interests for expenses. They consider that the new policy will lead to a better transparency of the funding costs and makes the financial statements of X comparable with those of other enterprises in the branch.

Capitalised interests were of: 5,460 m.u., in N-1, and 10,920 m.u., in financial years prior to N-1.

The Profit and Loss Account for financial year N shows an accounting result before deducting the interest expenses and the income taxes of 63,000 m.u., interest expense of the current financial year 6,300 m.u. and income taxes 9,072 m.u.

The enterprise has not yet recognised any depreciation of the building because it is not yet in use.

The Profit and Loss Account published in financial year N-1 is presented as such:

Table 1

The Profit and Loss Account published in financial year N-1

Profit from extraordinary activities before interest and income taxes	37,800
Interest expense	-
Profit from extraordinary activities before taxation	37,800
Income taxes	- 6,048
Net profit	31,752

N-1 opening, the retained earnings was 42,000 m.u., and closing retained earnings was 73,752 m.u.

Tax rate is 16%.

The corporate funds of company X is 21,000 m.u. We presuppose that there are no other components of stockholders' equity except the corporate funds and retained results.

The Profit and Loss Account for financial year N and for financial year N-1 (restated) is presented as follows:

Table 2

The Profit and Loss Account for financial year N and for financial year N-1

Items	N	N-1 (restated)
Profit from extraordinary activities before interest and income taxes	63,000	37,800
Interest expense	- 6,300	- 5,460
Profit from extraordinary activities before taxation	56,700	32,340
Income taxes	- 9,072	- 5,174.4
Net Profit	47,628	27,165.6

The situation of the variation of stockholders' equity is presented as follows:

Table 3

The situation of the variation of stockholders' equity

Items	Capital stock	Retained earnings	Total
N-1 opening stockholders' equity	21,000	42,000	63,000
Change in accounting policy (10,920 – 10,920x16%)		- 9,442.8	- 9,442.8
N-1 opening stockholders' equity as restated	21,000	35,557.2	53,557.2
N-1 result		27,165.6	27,165.6
= N-1 closing stockholders' equity	21,000	62,722.8	80,722.8
N result		47,628	47,628
= N closing stockholders' equity	21,000	110,350.8	128,350,8

Information provided in Explanatory Notes:

During N, the company changed the policies with respect to the treatment of borrowing costs. In previous financial years, the company expenses rather than capitalise such costs. Currently, they are considered expenses of current financial year. The managers consider that the new policy will lead to a better transparency of the funding costs and makes the financial statements of X comparable to those of other enterprises in the branch. This change in accounting policy has been accounted for retrospectively and the comparative information for N-1 has been restated. The effects of the change on N-1 and on financial years prior to N-1 are:

Table 4

The effects of the change on N-1 and on financial years prior to N-1

Information	Effect on N-1
Interest expense increase	5,460
Tax expense lower	873.6
Result lower	4,586.4
Information	Effect on financial years prior to N-1
Result lower (10,920 – 10,920x16%)	9,172.8
Fixed assets and retained profit lower to 31.12.N-1 (10,920+5,460)x 84%	13,759.2

A *change* in accounting policy must not be confused with adopting a *new accounting policy*. The following are *not* changes in accounting policy:

a) the initial adoption or alteration of an accounting policy necessitated by events or transactions that are clearly different in substance from those previously occurring, nor b) the initial adoption of an accounting policy in recognition of events or transactions occurring for the first time or that were previously immaterial in their effect.

For **example**, suppose that a company has been using completed-contract accounting and then adopts the percentage-of-completion method for new contracts. If there has been no change in the nature of the contracts, this is an accounting policy change (which should be applied retroactively to the previously existing contracts, as we will discuss in the next section). But if the new contracts are substantively different

from the earlier contracts, perhaps with longer terms or more estimable cost structures, then the new accounting policy is not necessarily a *change* in accounting policy. Instead, the apparent policy change results from applying a policy to a new set of economic circumstances. The distinction between a change in policy and adopting a new policy for different economic events is not always easy to discern.

2.2. Changes in accounting estimates

As a result of the uncertainties inherent in business activities, many financial statements items cannot be measured with precision, but can only be estimated. Normally, the estimation process involves judgements based on latest information available. For instance, estimates may be required of bad debts, inventory obsolescence or the useful lives or expected pattern of consumption of economic benefits of tangible and intangible assets. Also, one of the fields, in which the judgements referring to estimates, occupies a central position, is represented by the entire problem of depreciation, provisions and assets depreciation.

The changes in accounting estimates are difficult to accept mainly, due to the action of the method permanence principle. Although, when new circumstances bring into discussion the prior estimate, a change in the accounting estimate can be used.

The differentiation between changes in accounting policies and changes in accounting estimates might cause particular difficulties for the measurement of insurance contracts. Those measurements are, considering the uncertainty typical for insurance risk, estimates. IAS 39.34 specifies that “an estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience. ...”

Sometimes, it is difficult to distinguish between a change in accounting policy and a change in an accounting estimate. In such cases, the change is treated as a change in an accounting estimate, with appropriate disclosure.

IAS 8 stipulates that the effect of a change in an accounting estimate shall be recognised prospectively by including it in profit or loss in:

- (a) the period of the change, if the change affects that period only; or
- (b) the period of the change and future periods, if the change affects both.

Example 2

Enterprise X purchased a programme product, at the price of 112,000 m.u., at 01.01.N-2. The management of the enterprise estimated a utility period of 5 years, for this programme. Also, a third party engaged to purchase this product at the end of its utility period, at a price of 7,000 m.u. Taking into consideration the evolution of progress in the field of informatics, after 2 years, the management re-examines the utility period of the asset and estimates that the most adequate residual period is of 2 years. The estimates regarding the residual value do not change.

For N-2 and N-1, the enterprise calculates and accounts a depreciation of: $(112,000 - 7,000) / 5 = 21,000$ m.u.

$$\begin{array}{rcl}
 6811 & = & 2808 \quad 21,000(x2) \\
 \text{“Operating expenses related to} & & \text{“Amortisation of other} \\
 \text{depreciation of fixed assets”} & & \text{intangible assets”}
 \end{array}$$

Net accounting value after the second year will be: $(112,000 - 42,000) = 70,000$ m.u. In each N and N+1 the enterprise will have operating costs regarding the amortisation of: $(70,000 - 7,000) / 2 = 31,500$ m.u.

6811	=	2808	31,500(x2)
“Operating expenses related to depreciation of fixed assets”		“Amortisation of other intangible assets”	

Conclusion: The change in accounting estimate affected the result of the current N because the expense is with 10,500 m.u. higher, and also the results of the future N+1. The action of the change in accounting estimate is always made prospectively and not retrospectively.

2.3. Prior period errors

Except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the error, an entity shall correct material prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery by:

(a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or

(b) if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.

Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements.

Errors can be connected to recognising, evaluating and presenting an element of the financial statements or the information provided in connection to it. If the errors have been discovered during the financial year when they were made, they are corrected before the financial statements are sanctioned to be published. Yet, fundamental errors are sometimes discovered just in the following financial years.

The Explanatory Notes (annexes) must provide a complete informing on the nature of the error effect.

Some of the errors noticed according to IAS 8 have a small value and during the financial year it is usually used a complementary correction formulae.

Example 3

In N it has been drawn up a depreciation plan for a building whose annual depreciation was of 110,500 m.u. In N+1 it is noticed the error in the depreciation plan according to which the annual depreciation is of 110,380 m.u. It is a small error and its correction is made such as:

6811	=	2812	120
“Operating expenses related to depreciation of fixed assets”		“Building depreciation”	

The conclusions of our analyse are summarizing in the following table:

Table 5

Summary of accounting changes and reporting approaches

Type of accounting change	Accounting approach recommended	Accounting policy	
		Catch up adjustment identified with	Comparative statements and results of prior years
Accounting Policy			
Usual situation	Retroactive with restatement	Opening retained earnings retroactively restated in all affected prior periods.	Prior years' results restated to new policy
Able only to restate opening balances	Retroactive without restatement	Opening retained earnings of current period only.	Prior years' results remain unchanged
Accounting Estimate	Prospective	Catch-up adjustment not computed or reported	Prior years' results remain unchanged New estimates applied only to accounting for current and future periods.
Accounting Error	Retroactive with restatement	Opening retained earnings restated if the error has not washed out.	Prior years' results restated to correct the error.

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