This IFRS Supplement provides expanded discussions of accounting guidance under International Financial Reporting Standards (IFRS) for the topics in Intermediate Accounting. The discussions are organized according to the chapters in Intermediate Accounting (13th or 14th Editions) and therefore can be used to supplement the U.S. GAAP requirements as presented in the textbook. Assignment material is provided for each supplement chapter, which can be used to assess and reinforce student understanding of IFRS.

**DIRECT AND INDIRECT EFFECTS OF CHANGES**

Are there other effects that a company should report when it makes a change in accounting policy? For example, what happens when a company like Lancer has a bonus plan based on net income and the prior year’s net income changes when FIFO is retrospectively applied? Should Lancer also change the reported amount of bonus expense? Or, what happens if we had not ignored income taxes in the Lancer example? Should Lancer adjust net income, given that taxes will be different under average cost and FIFO in prior periods? The answers depend on whether the effects are direct or indirect.

**Direct Effects**

The IASB takes the position that companies should retrospectively apply the direct effects of a change in accounting policy. An example of a direct effect is an adjustment to an inventory balance as a result of a change in the inventory valuation method. For example, Lancer Company should change the inventory amounts in prior periods to indicate the change to the FIFO method of inventory valuation. Another inventory-related example would be an impairment adjustment resulting from applying the lower-of-cost-or-net realizable value test to the adjusted inventory balance. Related changes, such as deferred income tax effects of the impairment adjustment, are also considered direct effects. This entry was illustrated in the Denson example, in which the change to percentage-of-completion accounting resulted in recording a deferred tax liability.

**Indirect Effects**

In addition to direct effects, companies can have indirect effects related to a change in accounting policy. An indirect effect is any change to current or future cash flows of a company that result from making a change in accounting policy that is applied retrospectively. An example of an indirect effect is a change in profit-sharing or royalty payment that is based on a reported amount such as revenue or net income. The IASB is silent on what to do in this situation. U.S. GAAP (likely because its standard in this area was issued after IAS 8) requires that indirect effects do not change prior period amounts.

For example, let’s assume that Lancer Company has an employee profit-sharing plan based on net income and it changed from the weighted-average inventory method to FIFO in 2010. Lancer reports higher income in 2009 and 2010 if it used the FIFO method. In addition, let’s assume that the profit-sharing plan requires that Lancer pay the incremental amount due based on the FIFO income amounts. In this situation, Lancer reports this additional expense in the current period; it would not change prior periods for this expense. If the company prepares comparative
financial statements, it follows that it does not recast the prior periods for this additional expense.¹

If the terms of the profit-sharing plan indicate that no payment is necessary in the current period due to this change, then the company need not recognize additional profit-sharing expense in the current period. Neither does it change amounts reported for prior periods.

When a company recognizes the indirect effects of a change in accounting policy, it includes in the financial statements a description of the indirect effects. In doing so, it discloses the amounts recognized in the current period and related per share information.

**IMPRACTICABILITY**

It is not always possible for companies to determine how they would have reported prior periods’ financial information under retrospective application of an accounting policy change. Retrospective application is considered impracticable if a company cannot determine the prior period effects using every reasonable effort to do so.

Companies should not use retrospective application if one of the following conditions exists:

1. The company cannot determine the effects of the retrospective application.
2. Retrospective application requires assumptions about management’s intent in a prior period.
3. Retrospective application requires significant estimates for a prior period, and the company cannot objectively verify the necessary information to develop these estimates.

If any of the above conditions exists, it is deemed impracticable to apply the retrospective approach. In this case, the company prospectively applies the new accounting policy as of the earliest date it is practicable to do so. [1]

For example, assume that Williams Company changed its accounting policy for depreciable assets so as to more fully apply component depreciation under revaluation accounting. Unfortunately, the company does not have detailed accounting records to establish a basis for the components of these assets. As a result, Williams determines it is not practicable to account for the change to full component depreciation using the retrospective application approach. It therefore applies the policy prospectively, starting at the beginning of the current year.

Williams must disclose only the effect of the change on the results of operations in the period of change. Also, the company should explain the reasons for omitting the computations of the cumulative effect for prior years. Finally, it should disclose the justification for the change to component depreciation. [2]

¹The rationale for this approach is that companies should recognize, in the period the adoption occurs (not the prior period), the effect on the cash flows that is caused by the adoption of the new accounting policy. That is, the accounting change is a necessary “past event” in the definition of an asset or liability that gives rise to the accounting recognition of the indirect effect in the current period.
AUTHORITATIVE LITERATURE

Authoritative Literature References


QUESTIONS

1. What is the indirect effect of a change in accounting policy? Briefly describe the approach to reporting the indirect effects of a change in accounting policy.

2. Discuss how a change in accounting policy is handled when it is impracticable to determine previous amounts.

CONCEPTS FOR ANALYSIS

CA22-1 (Analysis of Various Accounting Changes and Errors) Joblonsky Inc. has recently hired a new independent auditor, Karen Ogleby, who says she wants “to get everything straightened out.” Consequently, she has proposed the following accounting changes in connection with Joblonsky Inc.’s 2010 financial statements.

1. At December 31, 2009, the client had a receivable of $820,000 from Hendricks Inc. on its statement of financial position. Hendricks Inc. has gone bankrupt, and no recovery is expected. The client proposes to write off the receivable as a prior period item.

2. The client proposes the following changes in depreciation policies.
   (a) For office furniture and fixtures, it proposes to change from a 10-year useful life to an 8-year life. If this change had been made in prior years, retained earnings at December 31, 2009, would have been $250,000 less. The effect of the change on 2010 income alone is a reduction of $60,000.
   (b) For its equipment in the leasing division, the client proposes to adopt the sum-of-the-years’-digits depreciation method. The client had never used SYD before. The first year the client operated a leasing division was 2010. If straight-line depreciation were used, 2010 income would be $110,000 greater.

3. In preparing its 2009 statements, one of the client’s bookkeepers overstated ending inventory by $235,000 because of a mathematical error. The client proposes to treat this item as a prior period adjustment.

4. In the past, the client has spread preproduction costs in its furniture division over 5 years. Because its latest furniture is of the “fad” type, it appears that the largest volume of sales will occur during the first 2 years after introduction. Consequently, the client proposes to amortize preproduction costs on a per-unit basis, which will result in expensing most of such costs during the first 2 years after the furniture’s introduction. If the new accounting method had been used prior to 2010, retained earnings at December 31, 2009, would have been $375,000 less.

5. For the nursery division, the client proposes to switch from FIFO to average cost inventories because it believes that average cost will provide a better matching of current costs with revenues. The effect of making this change on 2010 earnings will be an increase of $320,000. The client says that the effect of the change on December 31, 2009, retained earnings cannot be determined.

6. To achieve a better matching of revenues and expenses in its building construction division, the client proposes to switch from the cost-recovery method of accounting to the percentage-of-completion method. Had the percentage-of-completion method been employed in all prior years, retained earnings at December 31, 2009, would have been $1,075,000 greater.

Instructions

(a) For each of the changes described above, decide whether:
   (1) The change involves an accounting policy, accounting estimate, or correction of an error.
   (2) Restatement of opening retained earnings is required.

(b) What would be the proper adjustment to the December 31, 2009, retained earnings?
Financial Reporting Problem

Marks and Spencer plc (M&S)

The financial statements of M&S can be accessed at the book’s companion website, www.wiley.com/college/kiesoifrs.

Instructions

Refer to M&S’s financial statements and the accompanying notes to answer the following questions.

(a) Were there changes in accounting policies reported by M&S during the two years covered by its income statements (2007–2008)? If so, describe the nature of the change and the year of change.
(b) What types of estimates did M&S discuss in 2008?

BRIDGE TO THE PROFESSION

Professional Research

As part of the year-end accounting process and review of operating policies, Cullen Co. is considering a change in the accounting for its equipment from the straight-line method to an accelerated method. Your supervisor wonders how the company will report this change in accounting. It has been few years since he took intermediate accounting, and he cannot remember whether this change would be treated in a retrospective or prospective manner. Your supervisor wants you to research the authoritative guidance on a change in accounting policy related to depreciation methods.

Instructions

Access the IFRS authoritative literature at the IASB website (http://eifrs.iasb.org/). When you have accessed the documents, you can use the search tool in your Internet browser to respond to the following questions. (Provide paragraph citations.)

(a) What are the accounting and reporting guidelines for a change in accounting policy related to depreciation methods?
(b) What are the conditions that justify a change in depreciation method, as contemplated by Cullen Co.?