CPE ARTICLE:

What to Consider When Making AN ACCOUNTING CHANGE

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Curriculum: Accounting and Auditing

Level: Basic

Designed For: Accountants in business and industry

Objectives: Readers will be able to evaluate their alternatives for timing of adoption and transitions upon adoption when making either mandatory or voluntary accounting changes. Readers will be able to plan for GAAP requirements and consider the flexibility available in GAAP to best meet their company's objectives.

Key Topics: Adopting mandatory and voluntary accounting changes, when changes should be adopted, transition methods, impacts on the company, label adopters vs. serious adopters, and valuation consequences

Prerequisites: None

Advanced Preparation: None

Mandatory changes are scheduled for the next several years and companies will have to make some choices to adjust to new environments. The process of making a smooth transition to a new accounting method involves careful consideration of Topic 250 *Accounting Changes and Error Correction.*

Companies should consider the following issues as they plan the pervasive mandatory changes, as well as the narrower accounting choices within GAAP. Many of the general principles in the area of accounting changes have exceptions and scope limitations that may prevent a company from making the changes that are preferred. A lack of awareness of the disclosures required can cause a delay. A lack of awareness of the market interpretations can result in unintended consequences.

Mandatory Accounting Changes

Mandatory accounting changes are appearing in financial statements in a flurry over the next three years as changes in Financial Instruments, Revenue Recognition, Leases, Credit Losses, Derivatives and Hedging, and Goodwill Impairment occur (see Table 1). For each of these major issues, companies need to plan carefully to revise their accounting information systems to accommodate these changes.

However, even before the planning can begin, companies have decisions to make in order to have an orderly transition. The following three implementation issues will dictate the timing of the transition, the method of the transition and the preparation provided to financial statement users, investors and creditors.

1. When should the change be adopted? Some of the six upcoming accounting changes listed in Table 1 allow early adoption. In addition, private companies and not-for-profits have an additional year, offering a longer early adoption period. Factors to consider in opting for early adoption include the following.

Immediate simplification of accounting procedures – Some standards can prompt immediate cost savings. For example, ASU 2017-13 on Derivatives & Hedging allows joint deferral and recognition of portions of a cash flow hedge. ASU 2017-04 eliminates the estimation of fair value of the net identifiable assets of business reporting units with goodwill when completing quantitative testing for goodwill impairment.

Clarity of the new standards – Some standards have little ambiguity and contain pertinent implementation guidance for certain business contexts. However, even the Financial Accounting Standards Board (FASB) anticipated difficulty interpreting ASU 2014-09 on Revenue Recognition.

Companies have submitted 125 issues to the Revenue Recognition Transition Resource Group (RRTRG), resulting in six ASUs on revenue recognition issued after the initial pronouncement and a one-year deferral of its effective date. Only recently at the RRTRG's November 2017 meeting did it conclude that there are no future expected changes. However, implementation issues are still being resolved for leases. For example, the exposure draft issued on Sept. 25, 2017 on land easements provides an alternative to assess land easements for the applicability of Topic 842 criteria on leases only prospectively. Companies adopting ASU 2016-02 on leases may want to wait on resolution of this issue prior to scheduling adoption.

Benefits of leading or following – Early adopters exude transparency and competency, but later adopters can learn from the experience of the leading companies, especially when there are major changes. For example, Workday has promoted its early adoption of ASU 2014-09 Revenue Recognition as part of its strategy as an enterprise resource company to explicitly help

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Table 1

Year	Required Effective Date	Accounting Standards Update	Transition Method
2018	Annual periods beginning after 12/15/2017 and interim periods within those annual periods.	2016-01 Financial Instruments	• Cumulative-effect adjustment at the beginning of the fiscal year of adoption. • Prospective approach for equity securities without readily determinable fair values.
		2014-09 Revenue from Contracts with Customers	• Full retrospective or • Modified retrospective, which includes a cumulative effect adjustment to current period retained earnings. • Adoption for annual periods beginning after 12/15/2016 allowed.
2019	Annual periods beginning after 12/15/2018 and interim periods within those annual periods.	2016-02 Leases	• Modified retrospective with optional practical expedients. • Early adoption allowed.
		2017-12 Derivatives and Hedging	• Adjustment to hedging relationships existing as of the beginning of the fiscal year of adoption. • Cumulative-effect adjustment to cash flow and net investment hedges for change in treatment of ineffectiveness. • Early adoption allowed
2020	Annual periods beginning after 12/15/2019 and interim periods within those annual periods.	2016-13 Financial Instruments – Credit Losses	• Modified retrospective. • Some assets use prospective approach. • Adoption for fiscal years beginning after 12/15/2018 allowed.
	Impairment tests beginning after 12/15/2019.	2017-04 Intangibles – Goodwill and Other	• Prospective approach. • Adoption for impairment tests after 1/1/2017 allowed.

others in this same process. However, even Workday advocates that companies involve their auditors from the beginning of planning through implementation. In addition, networking groups, professional associations and trade groups can provide a check on implementation questions.

2. Which transition method should be used? Any combination of the three main transition methods for accounting changes may be designated in new ASUs.

The retrospective treatment requires a complete restatement of prior financial statements so that all comparative financial statements use the same accounting method.

The prospective treatment begins using the new method in the period of adoption with no changes to past financial statements at all.

The modified retrospective treatment takes a middle approach with the new treatment in the period of adoption and a single cumulative effect adjusting beginning retained earnings to the value as if the new method had always been used.

When a choice of methods is offered, as with ASU 2014-09 Revenue from Contracts with Customers, the company needs to consider the tradeoffs. Full retrospective method has the greatest transparency and best trend information.

Methods that allow a cumulative effect require less research and documentation, but may lose the benefit of readily understandable trends through time. Thus, choices made to reduce information costs now may lock a company into a disadvantageous presentation of financial statement material long into the future.

3. Can the impact be estimated and disclosed prior to the adoption date? Long adoption windows mean long planning horizons. Staff Accounting Bulletin 74 (SAB 74) requires companies to provide information in anticipation of mandatory changes in accounting and greater transparency of these disclosures may ease the transition with investors and creditors.

Notifying users of the impending impact in footnotes prior to adoption can give the company a chance to make its case for any advantage or disadvantage that is expected. For example, Boeing announced its adoption of ASU 2014-09 Revenue Recognition in 2018, but acknowledged in its 2014 annual report that there would be possible changes in the "timing of revenue recognition for certain transactions." Its 2016 annual report provided the stronger statement of expectation of "a material impact on our income statement and balance sheet."

Scholars have looked at the phenomenon of early adoption of mandatory accounting standards from a different perspective. Are there any systematic characteristics that describe early adopters and separate them from those who only meet the deadline? Not surprisingly, the decision to early adopt seems to have some systematic elements (Espahbodi and Hamer, 1996). Early adoption is more likely when the accounting change increases income and eases debt constraints. In addition, early adopters are more likely to smooth their income through early adoption. Early adopters may jump on an accounting change that lowers (increases) their income if they anticipate a high (low) income from operations.

Voluntary Accounting Changes

Voluntary accounting changes use alternatives already present in GAAP, allowing a company to improve its own accounting methods or adjust them to the company's changing business context and needs. Companies may hesitate to make a change because of the cost of changing IT systems or to maintain consistency in methods. However, the requirement to retroactively adjust for most accounting changes preserves the consistency of comparative financial statements. Companies should carefully consider the following.

Some changes are not changes in accounting method at all. For example, since 2005 a change in depreciation method has been treated as a change in accounting estimate "effected by a change in accounting principle." In addition, periodic changes in estimates of accruals due to economic and business conditions such as estimations of bad debt expense or warranty expense do not trigger GAAP for accounting method changes.

Some accounting changes have a broad scope and require the same accounting for similar items; others have a narrow scope and allow different accounting for similar items. For example, a company can separately consider fair value accounting for each investment in debt securities (ASC 825-10-25-2), but a company selecting successful efforts or full cost method of accounting for oil and gas activities must adopt one method for all of its operations and the operations of its subsidiaries (ASC 932-10-S99-1(b)).

Some accounting changes can only occur at the time of a particular event or period. The overall recommendation, but not requirement, in Topic 250 is to have accounting changes occur in the first interim period of a fiscal year. However, timing of accounting changes vary considerably with the type of change. For example, GAAP allows the adoption of pushdown accounting, which allows a subsidiary to adjust the valuation of its net assets to fair value to match the value used by its parent company only at the time of a change in control (ASC 805-50-05-9). In contrast, private company alternatives on intangible assets and derivatives issued in Updates 2014-02, 2014-03, 2014-07 and 2017-08 can be adopted initially at any time without the accounting change being subject to Topic 250.

Some reasons pass muster and some do not. Companies must disclose their reason for the change, considering preference from the point of view of its responsibility to financial statement users. This concise quote from the 2016 annual report of Manitowoc Company, Inc. showcases the most common issues prompting accounting changes (emphasis added):

The FIFO method is preferable as it results in *uniformity* across its global operations, *aligns* with how the Company internally manages inventory, provides *better matching* of revenues and expenses, and *improves comparability* with its peers.

Some accounting changes can be made without retroactive restatement. Topic 250 states that other transitions are allowed

when restatement is impracticable. However, impracticability is a high standard. When information is unavailable despite every reasonable effort or when required judgments cannot be made objectively for past situations or when management intent cannot be independently substantiated (ASC 250-10-45-9), companies can use a cumulative adjustment to beginning retained earnings or, if necessary, companies can treat the change prospectively.

One final factor that companies should consider before making an accounting change is the perception of external stakeholders. This topic has been of interest to accounting researchers for many years and results suggest that there are measurable market effects when accounting changes occur.

Daske, Hail, Leuz and Verdi, in their study titled "Adopting a Label: Heterogeneity in the Economic Consequences around IAS/IFRS Adoptions," examine liquidity and cost of capital effects for two kinds of IFRS adopters:

- firms that make very few accounting changes and adopt IFRS in name only, called label adopters, and
- firms that adopt IFRS as a strategy to increase transparency, called serious adopters.

They find that serious adopters are associated with an increase in liquidity and a decrease in cost of capital, whereas label adopters are not. This study demonstrates that users could detect the difference between an accounting change in which true financial reporting improvement is achieved and one that just reshuffles numbers.

Linck, Lopez and Rees in their study titled "The Valuation Consequences of Voluntary Accounting Changes" examine alternative motives behind voluntary accounting method changes. While some managers claim that voluntary accounting changes are made to increase the informativeness of earnings, others argue that they are made to manage earnings and influence the stock price. Their findings suggest that voluntary accounting changes influence earnings informativeness to a small extent only. Further, the market recognizes the influence of accounting methods and efficiently processes the valuation implications, so that accounting changes alone do not increase company valuation.

Accountants can take this summary and help ensure that the company is addressing the right issues and risks and can adequately support the impact of accounting changes.

Works Cited

Daske, H., L. Hail, C. Leuz, and R. Verdi. "Adopting a label: Heterogeneity in the Economic Consequences around IAS/IFRS Adoptions." *Journal of Accounting Research*, vol. 51, no. 3, 2013, pp. 495-547.

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Our Advice.

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1 What is the required effective date for public businesses adopting Accounting Standards Update 2016-02 Leases?

- **A.** December 15, 2018.
- **B.** For fiscal years beginning after December 15, 2018.
- **C.** For fiscal years ending after December 15, 2018.
- **D.** For fiscal quarters beginning after December 15, 2018.

2 The serious adopters in the Daske, Hail, Leuz and Verdi study are associated with:

- **A.** An increase in the cost of capital and an increase in liquidity.
- **B.** An increase in the cost of capital and a decrease in liquidity.
- **C.** A decrease in the cost of capital and an increase in liquidity.
- **D.** A decrease in the cost of capital and a decrease in liquidity.

3 Which ASU can create immediate cost savings through simplified procedures?

- **A.** ASU 2017-13
- **B.** ASU 2016-13
- **C.** ASU 2014-09
- **D.** ASU 2016-02

4 Which transition method provides the best information for trend analysis?

- **A.** Modified retrospective method.
- **B.** Full retrospective method.
- **C.** Prospective method.
- **D.** Change in estimate method.

5 The Financial Accounting Standards Board helps companies implement new mandatory standards by:

- **A.** Issuing clarifying accounting standard updates on relevant issues.
- **B.** Previewing submissions before they are sent to the SEC.
- **C.** Ignoring feedback from companies once an ASU is issued.
- **D.** Accepting no amendments to the codification topic until implementation is completed.

6 Mandatory accounting changes for newly issued accounting standard updates:

- **A.** Can always be adopted immediately.
- **B.** Have a common adoption date for all organizations.
- **C.** Usually offer less time prior to adoption for non-public business entities.
- **D.** Often have required adoption dates that differ with the type of organization.

7 Retrospective treatment of an accounting change:

- **A.** Is rarely selected as the way to transition to a new accounting method.
- **B.** Changes prior income statements, but not balance sheets.
- **C.** Requires re-statement of past financial statements.
- **D.** Is used when a company changes depreciation methods.

8 Which of the following is true about the modified retrospective treatment of an accounting change?

- **A.** Modified retrospective treatment requires the company to make changes to only the comparative financial statements provided.
- **B.** Modified retrospective treatment includes an adjustment to beginning net assets of the period of change.
- **C.** Modified retrospective treatment is the same as prospective treatment.
- **D.** Modified retrospective treatment is an allowed alternative for companies adopting ASU 2014-09 Revenue from Contracts with Customers.

9 All companies and organizations will be using the same accounting method for credit losses:

- **A.** For fiscal years beginning after 12/15/2018.
- **B.** For fiscal years beginning after 12/15/2019.
- **C.** For calendar years beginning after 12/31/2018.
- **D.** For calendar years beginning after 12/31/2019.

10 Delaying adoption of an accounting change until the required date has the advantage that:

- **A.** The income effects will be smaller.
- **B.** The auditor will have less experience with auditing the accounting change.
- **C.** The company will be able to consult with its peers in planning for the change.
- **D.** The company can avoid disclosing estimates of the impact of the accounting change before that date.

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