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# Statement of Federal Financial Accounting Standards 21: Reporting Corrections of Errors and Changes in Accounting Principles, Amendment of SFFAS 7, Accounting for Revenue and Other Financing Sources

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## Status

Issued	October 16, 2001
Effective Date	For periods beginning after September 30, 2001.
Affects	SFFAS 7
Affected by	None.

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## Summary

This Statement amends the standard on Prior Period Adjustments contained in Statement of Federal Financial Accounting Standards 7, *Accounting for Revenue and Other Financing Sources* (SFFAS 7), which was issued in April 1996.

Paragraph 76 of SFFAS 7, entitled Prior Period Adjustments, addresses accounting changes and errors that affect prior period financial statements. It does not permit reporting entities, when presenting prior period financial statements for comparative purposes, to restate prior period financial statements to show the effect of the accounting errors.

The unforeseen result is that reporting entities that have material errors in their prior period financial statements are unable to present them for comparative purposes without creating both a dilemma for auditors and confusion for users. The dilemma for the auditors is that they would have to qualify their opinion on the prior period financial statements whether or not they had been restated. If prior period statements were presented that contained a material error, auditors would have to qualify their opinion. On the other hand, if prior period statements were presented and balances had been corrected for an error, auditors would still have to qualify their opinion because such restatement would not be in accordance with the existing standard. The confusion for the user derives from the difficulty inherent in comparing the financial statements for two or more periods when the effect of the error is not shown in the prior periods' financial statements.

To correct this situation, the amendment requires that when material errors are discovered in prior period financial statements, all statements presented must be restated to correct the error.

The Board has retained the current requirement that prior period financial statements not be restated for changes in accounting principles, unless otherwise specified in the transition instructions section of a new FASAB standard. The language addressing the

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requirements, however, has been revised to improve clarity and to require certain disclosures.

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## Introduction

1. Statement of Federal Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources*, became effective for fiscal year 1998. It includes a section describing how reporting entities should handle prior period adjustments.
2. The Section on Prior Period Adjustments states:

76. Prior period adjustments should be limited to corrections of errors and accounting changes with retroactive effect, including those occasioned by the adoption of new federal financial accounting standards, and should be recognized and measured under applicable standards. Adjustments should be recognized as a change in cumulative results of operations (rather than as an element of net results of operations for the period). Prior period financial statements should not be restated for prior period adjustments recognized in the current period.
3. When SFFAS No. 7 was issued, the Board believed that having reporting entities restate prior period financial statements for prior period adjustments would create an unnecessary burden at a time when FASAB was still establishing a basic framework of standards.
4. However, disallowing restatement of prior period financial statements has had the effect of preventing reporting entities from presenting comparative financial statements when the prior period financial statements contain a material error that is discovered in the current period.
5. The Board has amended the standard to require that reporting entities restate prior period financial statements for material errors discovered in the current period, if such statements are provided for comparative purposes, and if the effect of the error would be material to the financial statements in either period.
6. The Board has chosen to retain the current methodology that prior period financial statements not be restated for changes in accounting principles, unless otherwise specified in the transition instructions section of a new FASAB standard. The language addressing the requirements, however, has been revised to improve clarity and to require certain disclosures.
7. The language in the standard has also been revised to distinguish between corrections of errors and changes in accounting principles. A change in accounting principle should be identified as such and no longer reported as a prior period adjustment.

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## Effective Date

8. This amendment would be effective for periods beginning after September 30, 2001, with earlier implementation encouraged.

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## Accounting Standard

9. Paragraph 76 of SFFAS No. 7, *Accounting for Revenue and Other Financing Sources*, Section Prior Period Adjustments, is superceded and replaced by Paragraphs 10 through 13 below.

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## Corrections of Errors

10. "Errors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared."<sup>1</sup> When errors are discovered after the issuance of financial statements, and if the financial statements would be materially misstated absent correction of the errors, corrections should be made as follows:
- (a) If only the current period statements are presented, then the cumulative effect of correcting the error should be reported as a prior period adjustment. The adjustment should be made to the beginning balance of cumulative results of operations, in the statement of changes in net position.
  - (b) If comparative financial statements are presented, then the error should be corrected in the earliest affected period presented by correcting any individual amounts on the financial statements. If the earliest period presented is not the period in which the error occurred and the cumulative effect is attributable to prior periods, then the cumulative effect should be reported as a prior period adjustment. The adjustment should be made to the beginning balance of cumulative results of operations, in the statement of changes in net position for the earliest period presented.
  - (c) The nature of an error in previously issued financial statements and the effect of its correction on relevant balances should be disclosed. Financial statements of subsequent periods need not repeat the disclosures.
11. Prior period financial statements should only be restated for corrections of errors that would have caused any statements presented to be materially misstated.

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<sup>1</sup> Accounting Principles Board Opinion No. 20, par. 13.

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## Changes in Accounting Principles

12. A change in accounting principle is a change from one generally accepted accounting principle to another one that can be justified as preferable. For the purposes of this standard, changes in accounting principles also include those occasioned by the adoption of new federal financial accounting standards.
13. Unless otherwise specified in the transition instructions section of a new FASAB standard, for all changes in accounting principles that would have resulted in a change to prior period financial statements:
  - (a) The cumulative effect of the change on prior periods should be reported as a “change in accounting principle.” The adjustment should be made to the beginning balance of cumulative results of operations in the statement of changes in net position for the period that the change is made.
  - (b) Prior period financial statements presented for comparative purposes should be presented as previously reported; and
  - (c) The nature of the changes in accounting principle and its effect on relevant balances should be disclosed in the current period. Financial statements of subsequent periods need not repeat the disclosure.

<p>The provisions of this Statement need not be applied to information if the effect of applying the provision(s) is immaterial. Refer to Statement of Federal Financial Accounting Concepts 1, <i>Objectives of Federal Financial Reporting</i>, chapter 7, titled <i>Materiality</i>, for a detailed discussion of the materiality concepts.</p>
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## Appendix A: Basis For Conclusions

This Statement may be affected by later Statements. The FASAB Handbook is updated annually and includes a status section directing the reader to any subsequent Statements that amend this Statement. Within the text of the Statements, the authoritative sections are updated for changes. However, this appendix will not be updated to reflect future changes. The reader can review the basis for conclusions of the amending Statement for the rationale for each amendment.

14. This appendix summarizes some of the considerations deemed significant by the Board in reaching the conclusions in this Statement. It includes the reasons for accepting certain approaches and rejecting others. Individual members gave greater weight to some factors than to others.
15. The Board received sixteen responses to the ED. All but one respondent were in support of the amendment. The Board did not rely on the number in favor of or opposed to a given position. Information about the respondent's majority view is provided only as a means of summarizing the comments. The Board considered the arguments in each response and weighed the merits of the points raised. The respondent's comments are summarized below.

	<b>Federal</b>	<b>Non-federal</b>
Users, academics, others		2
Auditors	2	
Preparers and financial managers	12	

16. Seven respondents approved the amendment without further comment. Four approved the amendment but requested clarifying language, which has been incorporated into the standard. Two approved the amendment but would have preferred that the standard allow restatement for changes in accounting principles.
17. One respondent disapproved of the amendment because they believe the amendment will create additional confusion regarding the closing of prior period accounts and the subsequent issuance of financial statements.

## Corrections of Errors

18. When SFFAS No. 7 was issued, the Board believed that having reporting entities restate prior period financial statements for prior period adjustments would create an unnecessary



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burden at a time when FASAB was still establishing a basic framework of standards. Changes in the federal accounting environment in the ensuing years have lessened these concerns. With the government's increasing ability to produce accurate and sophisticated financial statements, the Board is more concerned with encouraging reporting entities to produce financial statements that are most useful to managers and other users.

19. Although comparative financial statements are not required by any of the accounting standards setting boards, it is generally held that "the presentation of comparative financial statements in annual and other reports enhances the usefulness of such reports and brings out more clearly the nature and trends of current changes affecting the enterprise."<sup>2</sup>
20. Reporting entities also recognize that presenting comparative statements greatly enhances the overall usefulness of financial statements. Despite the advantages of providing comparative statements, however, at least one governmental entity has been constrained from presenting its prior year statements because they contain a material error.
21. The Board has deliberated on the effects of the existing standard precluding restatement to correct errors on presentation of comparative financial statements. Although it believes that the considerations in effect at the time the existing standard was issued were valid, it has concluded that potentially losing or delaying the benefit of comparative statements now outweighs these considerations.
22. The Board concluded that the standard for Prior Period Adjustments should be amended to specifically require that prior period financial statements presented for comparative purposes be restated to correct material errors, and that restatement should be limited to only material errors.

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## Changes in Accounting Principles

23. Although the Board has chosen to retain the current methodology for reporting changes in accounting principle, it has revised the language to improve clarity and to require certain disclosures. The Board may consider exceptions to this decision, if warranted, for accounting standards issued in the future. It may also further examine issues raised by respondents regarding changes in accounting principles.

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<sup>2</sup> Accounting Research Bulletin 43, Chapter 2A, paragraph 101.

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## Other Accounting Changes

24. Although accounting estimates and changes in reporting entity are identified as accounting changes in other accounting literature, the Board did not address these issues because they require further study and were not addressed in paragraph 76 of SFFAS No. 7.

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## Board Approval

25. This statement was approved by unanimous vote of the Board.