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Video Transcription: Reporting a Change in Accounting Policy

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Hi, my name is Alex. In a previous video we looked specifically at how to identify what is a change in accounting policy. Once you have identified that you have a change in accounting policy, do you know how to deal with that change in accounting policy? The general principle to keep in mind is that once you have changed your accounting policy, you need to apply that new policy to all the amounts that you present on your financial statements. In other words, your assets and liabilities, revenue expenses and reserves. Now the usual way in which we deal with an accounting policy is that we redo all our previous financial statements, in terms of the new accounting policy. We show the current year's amounts and the prior year's amounts using the new accounting policy. This is what we call "retrospective re-statement".

And retrospective re-statement means that we re-state all our financial statements as though we had always applied the new policy. That means current year's profits, prior year's profits as well as all our assets and liabilities.

And in terms of IFRS, what that actually implies is that we need to prepare three statements of financial position: the current year, the comparative year and the position at the beginning of the comparative year. In order to do an accounting policy change what you actually need is to have all the assets and liabilities on the old policy and on the new policy measured at those three relevant dates: the current year end, the comparative year end and the year end prior to that. And once you have got your assets and liabilities, you'll then be able to work out the impact on your profit because remember that profit, or comprehensive income, is the movement between net assets. Let's take an example to illustrate. Let's assume that you are going to change your accounting policy from the weighted average to first-in-first-out or FIFO basis.

What you need to do is have the inventory figures for all those three relevant dates calculated on the weighted average basis and on the FIFO basis, and from that we will be able to work out the impact of that accounting policy change. In this video I am going to focus just on the changes on inventory balances.

In reality, there will be tax consequences. Changing the carrying amount of an asset will always change either your current tax responsibilities or deferred tax. But to keep the principle clear, I am going to focus just on the inventory adjustment and ignore the tax adjustments.

So, looking at the figures we have got, we have got three year-ends: current year, one year ago: T–1 and two years ago: T–2. We have got the inventory balances calculated both on the FIFO basis and on the weighted average basis. Let's assume that our financial records had been prepared using the weighted average basis. What we are then going to have to do is we are going to have to update those financial records to reflect them on the new policy and we are going to do that by putting through the following journal entry: debit inventory: 40 000, credit retained income: 35 000 and credit cost of sales: 5 000. Let's think about why that journal entry is correct. Focusing firstly on the inventory. On the weighted average basis at the end of the year, we would have had a closing inventory figure of 500 000. In terms of the new policy that needs to be 540 000. Debiting it by 40 000 will get the correct balance.

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It is important to note that that ledger account is not an IFRS requirement, it is a working document and therefore, although we are going to show different figures in our Statements of Financial positions, we do not need to go and change the ledger balance. What we do need to do is make sure that the closing balance is 540 000, which will imply that next year's opening balance will be 540 000. So, we will debit inventory with 40 000.

The 35 000 credit to retained income shows the cumulative effect of the change in accounting policy at the beginning of the current year and that is going to be taken to retained income because that cumulative effect is the same effect on cost of sales in prior years if our inventory figure was R35 000 higher, our cost of sales must have been R35 000 lower and therefore our retained income will be increased by 35 000. The 35 000 is the cumulative difference. The balancing figure of 5 000 is the impact on the current year, 40 000 was the cumulative difference at the end of the year, 35 000 the cumulative difference at the beginning of the year, which must imply that the impact on the current year is the difference of 5 000. But we can unpack that 5 000 and try and understand it a bit better.

Remember, that cost of sales is opening inventory plus purchases minus closing inventory. Now purchases is what you paid to your suppliers and obviously that is not impacted by your accounting policies. But opening inventory and closing inventory both will be. If we change our accounting policy, the impact is going to be to increase our opening inventory by 35 000. We are going to decrease our closing inventory by 40 000. Increasing our opening inventory increases our cost of sales, increasing our closing inventory decreases our cost of sales. The overall impact is a decrease of 5 000, hence the credit to cost of sales. And once we have processed that journal entry our accounting records will correctly reflect the amount.

Now it's important to think a little bit more deeply about that 35 000 adjustment to retained income. That is the cumulative effect at the beginning of the current year and remember what we do need to do is we need to restate last year's profit. In other words, we need to isolate how much of that 35 000 relates to last year's profit. Now, from a journal entry perspective that's irrelevant because changing last year's profit is going to change retained income, so we can split it but there is no point in doing that from the journal entry's perspective because it is all going to go to retained income. But for disclosure purposes we need to isolate the impact on last year's profit or last year's cost of sales.

Now the cumulative difference at the end of the previous year: T–2 is 33 000. The difference between the FIFO inventory figure of 450 000 and the weighted average figure of 417 000. At the beginning of the current year the cumulative difference was 35 000, at the beginning of the year, prior to that the cumulative difference, was 33 000. The difference on that year: 2 000. We can also go and focus on last year's cost of sales. Same approach we followed for the current year. Opening inventory went up 33 000, purchases are unchanged, closing inventory went up 35 000 and therefore cost of sales decreased by 2 000. So we are going to reduce our cost of sales figure for last year by 2 000, having the impact of increasing our profit by 2 000.

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It's important to remember that when we prepared our financial statements last year, we prepared that using the weighted average policy and now for that same financial year, when it is a comparative year, we are going to use the new policy of FIFO. Now, in order to demonstrate the integrity of the information, we can't just show different figures for last year than what we had presented last year. So what we need to do is highlight how those figures have changed and why those figures have changed.

When we prepare our Statement of Changes in Equity, focusing just on the retained income column, the opening balance that we are going to show at the beginning of the comparative year, in other words, T–2, is going to be the figure that we had on the old weighted average policy. Then what we are going to do is show the cumulative effect at T–2 of the difference between those two policies, the R33 000 increase. Then we are going to have a figure, which is going to show our retained income on the new policy, restated for the effect, and from then on we are going to apply the new policy. So when we recognise the profit figure for last year, we are going to do so on a FIFO basis. It's going to be R2 000 higher than what it was on the weighed average basis. Then we'll have the closing balance at the end of last year calculated on a FIFO basis and then we will bring in the current year's profits again on the FIFO basis.

If we focus on the movements, the cumulative difference at the end of the comparative year will be the 35 000 difference we looked at before, and the cumulative difference at the end of the current year will be the 40 000 cumulative difference at the end of the year. In other words, the FIFO minus the weighted average, the FIFO figure of 540 000 and the weighted average figure of 500 000.

Apart from the fact that we have ignored tax, what we have done here is got all the figures that we need to deal with an accounting policy change and notice how I have done that. I have done it by getting the assets and liabilities at three reporting dates and from that I can calculate the impact of that change in accounting policy. That is the approach that you need to follow when dealing with an accounting policy. Why don't you try it for yourself? Think about investment property, in terms of IFRS you have a choice of policy: fair value model and depreciated cost. Try what I have done here in respect of investment property policy change. In this video, we have looked at retrospective restatement of changes in accounting policy. It is important though that you understand that that is not the only way in which accounting policy changes can be recognised.
Where new IFRS is issued, that standard is going to have specific guidance on how to handle the transition from the old requirements to the new requirements. In many cases that guidance simply refers back to retrospective restatement in terms of IAS 8 but not always.

In some standards they have specific guidance about not changing your comparatives, doing things with a prospective effect only, but it is still a change in accounting policy. One important specific exception is in relation to revaluation of "property, plant and equipment". There are specific requirements there and effectively there is no restatement. It is treated as a change in estimate. Please do not fall into the trap of trying to learn how to do change in accounting policy disclosure, it is not going to help you in the long run. Take the time now to understand these key principles. It is going to pay you dividends so often in your future studies.
I hope you found this video helpful. Thank you and goodbye.