

technical factsheet 162

Prior year adjustments

Introduction

This factsheet explains when a prior year adjustment is required, the accounting and tax treatment and gives examples and disclosure requirements.

Financial Reporting Standard 3 (Reporting Financial Performance) defines prior period adjustments as: “Material adjustments applicable to prior periods arising from changes in accounting policies or from the correction of fundamental errors. They do not include normal recurring adjustments or corrections of accounting estimates made in the prior periods.”

FRS 3 states the following in paragraph 29: “Prior period adjustments should be accounted for by restating the comparative figures for the preceding period in the primary statements and notes and adjusting the opening balance of reserves for the cumulative effect. The cumulative effect of the adjustments should also be noted at the foot of the statement of total recognised gains and losses of the current period. Where practicable, the effect of a prior period adjustment on the results for the preceding period should be disclosed. Where it is not practicable to make this disclosure, that fact, together with the reasons, should be stated.”

When do prior period adjustments occur?

Prior period adjustments are material adjustments applicable to prior periods arising from either:

1. changes in accounting policies or
2. the correction of fundamental errors.

An entity’s accounting policies should be reviewed regularly to ensure they remain the most appropriate to its particular circumstances. Examples of when changes to accounting policies may be required are:

- a) when a company becomes a member of a group and the accounting policy is changed to that used by the group
- b) recently issued Financial Reporting Standards, Financial Reporting Exposure Draft (FRED) may indicate that a change in accounting policy may be appropriate.

To be fundamental an error must be so significant that it destroys the true and fair view and therefore the validity of the financial statements (Financial Reporting Standard 3 paragraph 63).

Financial Reporting Standard 18 (Accounting Policies) states the following in paragraph 54:

“A change to an estimation technique should not be accounted for as a prior period adjustment, unless

- a) it represents the correction of a fundamental error, or
- b) another accounting standard, a UITF Abstract or companies legislation requires the change to be accounted for as a prior period adjustment.”

Examples of changes of accounting policies or changes of estimation techniques

The following are changes to accounting policies as a result of different recognition policies:

- a) Changing from writing-off to capitalising interest relating to the construction of fixed assets (FRS 18 example 1)
- b) Changing from writing-off to capitalising development expenditure.
- c) Changing revenue recognition practices regarding the sale of goods and services.

The following are changes to accounting policies as a result of different measurement bases:

- a) Changing from measuring a class of fixed assets at depreciated historical cost to a policy of regular revaluation.
- b) Changing from measuring deferred tax liabilities on an undiscounted basis to measuring them on a discounted basis (FRS 18 example 6a).

- c) Changing from translating the results of foreign subsidiaries at closing rates to translating them at average rates for the year (FRS 18 example 7).

FRS 18 example 4a gives an example of a change to an estimation technique which therefore does not result in a prior year adjustment.

An entity has previously depreciated vehicles using the reducing balance method at 40% per year. It now proposes to depreciate vehicles using the straight-line method over 5 years, since it believes this better reflects the pattern of consumption of economic benefits.

This is not a change of accounting policy but is a change to an estimation technique, therefore would not be treated as a prior period adjustment.

Tax treatment

Change of accounting policy

For tax purposes a change of accounting policy which gives rise to a prior period adjustment from one valid basis of accounting to another gives rise to “adjustment income” (Sch 22,FA 2002: Chapter 17, ITTOIA 2005: CTA 2009). Income Tax (Trading and other Income) Act 2005 (ITTOIA 2005) has effect:

- a) for income tax purposes, for 2005-06 and subsequent tax years, and
- b) for corporation tax purposes, for accounting periods ending after 5 April 2005.

Corporation Tax Act 2009 has effect:

- a) for income tax purposes, for 2009-10 and subsequent tax years, and
- b) for corporation tax purposes, for accountancy periods ending on, or after, 1 April 2009.

Income tax

Although taxable as earnings, adjustment income does not form part of the trading profits for an individual or a partnership (s 228, ITTOIA 2005). For the 2008-09 tax return the amount should be shown separately in box 70 of the self employed (full) pages of the tax return or box 9 of the partnership pages.

Corporation tax

Adjustments arising as a result of a change in accounting policy are treated as occurring on the first day of the accounting period when the change in accounting policy occurs.

Fundamental Accounting Errors

For tax purposes a fundamental accounting error should be taxed in the year in which the error occurred. This would involve amending previous years’ income tax returns or corporation tax returns.

Worked Example

An entity has previously charged to the profit and loss account interest incurred in connection with the construction of tangible fixed assets. It now proposes to capitalise such interest, as permitted by FRS 15 “Tangible Fixed Assets”, since it believes this better reflects the cost of constructing those assets.

This is a change of accounting policy and if material would be disclosed as a prior period adjustment.

A Limited incurred interest costs on borrowings used in the construction of a fixed asset to be used for business purposes as follows:

	£
Year ended 31 December 2006	600,000
Year ended 31 December 2007	1,100,000
Year ended 31 December 2008	1,200,000

The fixed asset was completed in the year ending 31 December 2009. For both years ended 31 December 2006 and 2007 interest was charged to the profit and loss account. The directors propose to capitalise interest for the year ended 31 December 2008.

Profit and Loss Account

For The Year Ended 31 December 2008

	2008	2007
	£	As restated £
Sales	11,000,000	10,000,000
Cost of sales	<u>(6,000,000)</u>	<u>(5,800,000)</u>
Gross profit	5,000,000	4,200,000
Administrative expenses	<u>(3,000,000)</u>	<u>(2,800,000)</u>
Profit on ordinary activities before tax	2,000,000	1,400,000
Taxation	<u>(600,000)</u>	<u>(400,000)</u>
Profit on ordinary activities after tax	<u>1,400,000</u>	<u>1,000,000</u>

Balance Sheet

As at 31 December 2008

	£	2008 £	2007 as restated £
Tangible fixed assets		8,000,000	6,000,000
Current Assets			
Stocks	600,000		500,000
Debtors	400,000		650,000
Cash at Bank	<u>250,000</u>		<u>300,000</u>
	1,250,000		1,450,000
Creditors: Amounts falling			
Due within one year	<u>(700,000)</u>		<u>(300,000)</u>
Net Current Assets		<u>550,000</u>	<u>1,150,000</u>
Total Assets Less Current Liabilities		<u>8,550,000</u>	<u>7,150,000</u>
Capital and Reserves			
Called up Share Capital		100,000	100,000
Profit and Loss Account		<u>8,450,000</u>	<u>7,050,000</u>
Shareholders' Funds		<u>8,550,000</u>	<u>7,150,000</u>

Statement of Total Recognised Gains and Losses

	2008 £	2007 As restated £
Profit for the financial year	1,400,000	<u>1,000,000</u>
Prior year adjustment (as explained in note x)	<u>1,700,000</u>	
Total gains and losses recognised since last annual report	<u>3,100,000</u>	

Note y
Profit and Loss Account

	2008
	£
At beginning of year as previous stated	5,350,000
Prior year adjustment	<u>1,700,000</u>
At beginning of year as restated	7,050,000
Profit for the year	<u>1,400,000</u>
At end of year	<u>8,450,000</u>

Note x
Prior Year Adjustment

For the previous two years interest on loans used to finance costs of construction of tangible fixed assets were charged to the profit and loss account. Interest on such loans amounted to £600,000 in the year to 31 December 2006 and £1,100,000 in the year to 31 December 2007. In the year to 31 December 2008 the directors decided it would be more appropriate to include these interest costs, together with interest costs incurred in the year to 31 December 2008 of £1,200,000 in the cost of the tangible fixed asset. As this amounts to a change of accounting policy this has been disclosed as a prior period adjustment.

Journals Required

	Dr	Cr
	£	£
Year ended 31 December 2007		
Dr Tangible Fixed Assets (balance sheet)	1,700,000	
Cr Interest paid (profit and loss account)		1,100,000
Cr Profit and loss account reserves (balance sheet)		600,000

The above journal affects the comparative figures which then affect the opening balances for the year ended 31 December 2008.