Chapter 22

Accounting Changes and Error Analysis

Annual reports:

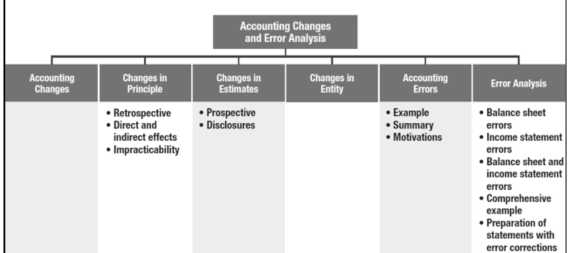
1

Learning Objectives

1. Types of accounting changes
2. Changes in accounting principles
3. Retrospective accounting changes
4. Impracticable changes
5. Changes in estimates
6. Changes in a reporting entity
7. Correction of errors
8. Economic motives for changing
9. Analyze effect of errors
10. (Appendix) Change from or to equity method

2

Accounting Changes and Error Analysis



3

Accounting Changes and Error Analysis

- Estimates and uncertainty may require adjustments when resolved
- Most accounting principle changes occurs because of new FASB rules
- Most errors occur because of improper revenue recognition (too early)

4

Learning Objective 1

- Types of accounting changes

5

Types of Accounting Changes

1. Change in accounting principle
2. Changes in accounting estimate
3. Change in reporting entity

6

Change In Accounting Principle

- Change from one generally accepted accounting principle to another
  - Change from LIFO to average cost
- Companies rarely voluntarily change
- New FASB pronouncement usually requires adoption of new principle
  - Timeline to comply (five years)

7

Change In Accounting Estimate

- Result of new information
  - Estimate of lives of depreciable assets
  - Estimate of warranty expense
  - Estimate of uncollectible sales on account

8

Change In Reporting Entity

- Change from reporting as one type of entity to another type of entity
  - Purchase or sale of subsidiaries

9

Error Correction

- Change from non-GAAP to GAAP
- Misapplication of GAAP
- Computational mistake

Not principle change

10

Learning Objective 2

- Changes in accounting principles

11

Changes in Accounting Principle

- Change from one GAAP accounting method to another GAAP method
  - Average cost to LIFO
  - Completed-contract to percentage-of-completion

Disclose nature of and reasons for change in principle and explanation of why newly adopted accounting principle is preferable

12

Reporting Changes

- Three approaches
  1. Currently (one time entry on income stmt)
  2. Retrospectively
  3. Prospectively (today forward)
- FASB requires retrospective approach
  - Users can better compare results from one period to next

GAAP changed: In past changes reported currently

13

Not Change in Accounting Principle

- Adoption of a new policy in recognition of events that have occurred for first time or that were previously immaterial is not an accounting change

14

Learning Objective 3

- Retrospective accounting changes

15

Retrospective Accounting Change Approach

- Company reporting change
  - Recalculates financial statements from each prior period as if new accounting principle had always been used
  - Adjust book value of assets, liabilities
  - One-time adjustment to retained earnings as of beginning of first year presented for lifetime cumulative effect on net income

IFRS uses retrospective approach

16

Accounting Change: Example 1

- In past used completed-contract method for long-term construction contracts
- In 2014 changed to percentage-of-completion method
- New approach provides a more appropriate measure of income earned
- For tax purposes, completed-contract method used in past and future
  - Tax rate, 40%

17

Accounting Change: Example 1

COMPLETED-CONTRACT METHOD
DENSON COMPANY
INCOME STATEMENT (PARTIAL)
FOR THE YEARS ENDED DECEMBER 31

	2012	2013	2014
Income before income tax	$400,000	$160,000	$190,000
Income tax (40%)	160,000	64,000	76,000
Net income	$240,000	$ 96,000	$114,000

PERCENTAGE-OF-COMPLETION METHOD
DENSON COMPANY
INCOME STATEMENT (PARTIAL)
FOR THE YEARS ENDED DECEMBER 31

	2012	2013	2014
Income before income tax	$600,000	$180,000	$200,000
Income tax (40%)	240,000	72,000	80,000
Net income	$360,000	$108,000	$120,000

Accounting Change: Example 1

Year	Pretax Income from: Percentage-of-Completion	Pretax Income from: Completed-Contract	Difference in Income: Difference	Difference in Income: Tax Effect 40%	Difference in Income: Income Effect (net of tax)
Prior to 2013	$600,000	$400,000	$200,000	$80,000	$120,000
In 2013	180,000	160,000	20,000	8,000	12,000
Total at beginning of 2014	$780,000	$560,000	$220,000	$88,000	$132,000
Total in 2014	$200,000	$190,000	$ 10,000	$ 4,000	$ 6,000

Description	Debit	Credit
Construction in Process	220,000	
Deferred Tax Liability		88,000
Retained Earnings		132,000

Journal entry beginning of 2014, year of change

19

Disclosure Requirements

- Nature of change in accounting policy
- Reason for change (why it is better)
- Method of applying change
- Description of prior period information that has been retrospectively adjusted
- Cumulative effect of change on retained earnings or other components of equity or net assets in balance sheet as of beginning of earliest period presented

20

Disclosure Requirements

- Effect of change on
  - Income from continuing operations
  - Net income
  - Net assets
  - Performance indicators (ratios)
  - Any financial statement line item of particular interest to lenders, investors
- Financial statement line items that do not change need not be shown

21

DENSON COMPANY
INCOME STATEMENT (PARTIAL)
FOR THE YEAR ENDED

	2014	2013 As Adjusted (Note A)
Income before income tax	$200,000	$180,000
Income tax (40%)	80,000	72,000
Net income	$120,000	$108,000

Note A: Change in Method of Accounting for Long-Term Contracts. The company has accounted for revenue and costs for long-term construction contracts by the percentage-of-completion method in 2014, whereas in all prior years' revenue and costs were determined by the completed-contract method. The new method of accounting for long-term contracts was adopted to recognize . . . [state justification for change in accounting principle] . . . and financial statements of prior years have been restated to apply the new method retrospectively. For income tax purposes, the completed-contract method has been continued. The effect of the accounting change on income of 2014 was an increase of $6,000 net of related taxes and on income of 2013 as previously reported was an increase of $12,000 net of related taxes. The balances of retained earnings for 2013 and 2014 have been adjusted for the effect of applying retroactively the new method of accounting. As a result of the accounting change, retained earnings as of January 1, 2013, increased by $120,000 compared to that reported using the completed-contract method.

22

DENSON COMPANY
RETAINED EARNINGS STATEMENT
FOR THE YEAR ENDED

	2014	2013	2012
Retained earnings, January 1	$1,696,000	$1,600,000	$1,360,000
Net income	114,000	96,000	240,000
Retained earnings, December 31	$1,810,000	$1,696,000	$1,600,000

Retained earnings, January 1, 2013 (percentage-of-completion)	$1,720,000
Retained earnings, January 1, 2013 (completed-contract)	(1,600,000)
Cumulative-effect difference	$ 120,000

23

Retained earnings, January 1, 2013 (percentage-of-completion)	$1,720,000
Retained earnings, January 1, 2013 (completed-contract)	(1,600,000)
Cumulative-effect difference	$ 120,000

After Change

DENSON COMPANY
RETAINED EARNINGS STATEMENT
FOR THE YEAR ENDED

	2014	2013
Retained earnings, January 1, as reported	—	$1,600,000
Add: Adjustment for the cumulative effect on prior years of applying retrospectively the new method of accounting for construction contracts		120,000
Retained earnings, January 1, as adjusted	$1,828,000	1,720,000
Net income	120,000	108,000
Retained earnings, December 31	$1,948,000	$1,828,000

24

Accounting Change: Example 2

- Accounting change occurs in 2012
- Changed from completed-contract to percentage-of-completion method for long-term construction contracts during
- For tax purposes, company uses completed-contract method
  - Used completed-contract in past and future
  - Adjust all tax consequences through Deferred Tax Liability account

25

Accounting Change: Example 2

- Record 2012 journal entries for change in accounting principle
- Calculate 2012 net income, ending R/E
- Beginning R/E 2011, $100,000
- Tax rate, 35%

	Pretax Income from Percentage-of-Completion	Pretax Income from Completed-Contract	Difference
2011	$780,000	$610,000	$170,000
2012	700,000	480,000	220,000

Accounting Change: Example 2

Date	Percentage-of-Completion	Completed-Contract	Difference	35% Tax Effect	Net of Tax
2011	$ 780,000	$ 610,000	170,000	59,500	$ 110,500
2012	700,000	480,000	220,000	77,000	143,000

Description	Debit	Credit
Construction in Process	170,000	
Deferred Tax Liability		59,500
Retained Earnings		110,500
Journal entry beginning of 2012, year of change		

27

	Pretax Income from Percentage-of-Completion	Pretax Income from Completed-Contract	Difference
2011	$780,000	$610,000	$170,000
2012	700,000	480,000	220,000

	2012	Restated 2011	Previous 2011
Pre-tax income	$ 700,000	$ 780,000	$ 610,000
Income tax (35%)	245,000	273,000	213,500
Net income	$ 455,000	$ 507,000	$ 396,500
Beg. Retained earnings	$ 496,500	$ 100,000	$ 100,000
Accounting change	110,500		
Beg. R/Es restated	$ 607,000	100,000	100,000
Net income	455,000	507,000	396,500
End. Retained earnings	$ 1,062,000	$ 607,000	$ 496,500

Description	Debit	Credit
Construction in Process	170,000	
Deferred Tax Liability		59,500
Retained Earnings		110,500
Journal entry beginning of 2012, year of change		

	2012	Restated 2011	Previous 2011
Pre-tax income	$ 700,000	$ 780,000	$ 610,000
Income tax (35%)	245,000	273,000	213,500
Net income	$ 455,000	$ 507,000	$ 396,500
Beg. Retained earnings	$ 496,500	$ 100,000	$ 100,000
Accounting change	110,500		
Beg. R/Es restated	$ 607,000	100,000	100,000
Net income	455,000	507,000	396,500
End. Retained earnings	$ 1,062,000	$ 607,000	$ 496,500

Direct and Indirect Effects

- Direct Effects
  - Retrospectively apply direct effects of a change in accounting principle
  - Line items directly impacted by change
- Indirect Effect
  - Changes to current or future cash flows of that result from making a change in accounting principle
  - Profit-sharing, bonuses based on N/I
  - Do not change prior period amounts

30

Brief Exercise 22-1

Wertz Construction Company decided at the beginning of 2014 to change from the completed-contract method to the percentage-of-completion method for financial reporting purposes. The company will continue to use the completed-contract method for tax purposes. For years prior to 2014, pretax income under the two methods was as follows: percentage-of-completion $148,600, and completed-contract $62,100. The tax rate is 35%.

Account Titles and Explanation	Debit	Credit
Construction in Process	86,500	
Deferred Tax Liability		30,275
Retained Earnings		56,225

Construction in Process = ($148,600 – $62,100) = **$86,500**
Deferred Tax Liability = [($148,600 – $62,100) x 35%] = **$30,275**

31

Brief Exercise 22-2

Wertz Construction Company decided at the beginning of 2014 to change from the completed-contract method to the percentage-of-completion method for financial reporting purposes. The company will continue to use the completed-contract method for tax purposes. For years prior to 2014, pretax income under the two methods was as follows: percentage-of-completion $119,500, and completed-contract $82,700. The tax rate is 33%. Wertz has a profit-sharing plan, which pays all employees a bonus at year-end based on 2% of pretax income.

Compute the indirect effect of Wertz's change in accounting principle that will be reported in the 2014 income statement, assuming that the profit-sharing contract explicitly requires adjustment for changes in income numbers.

Indirect effect $ 736

Difference in profit-sharing expense—prior years	
Pre-tax income—percentage-of-completion	$119,500
Pre-tax income—completed-contract	82,700
	$36,800
	x 2%
Indirect effect	**$736**

The indirect effect from prior years will be reported as a profit-sharing expense for year 2014.

32

Brief Exercise 22-3

Shannon, Inc., changed from the LIFO cost flow assumption to the FIFO cost flow assumption in 2014. The increase in the prior year's income before taxes is $1,213,800. The tax rate is 40%.

Account Titles and Explanation	Debit	Credit
Inventory	1,213,800	
Deferred Tax Liability		485,520
Retained Earnings		728,280

Deferred Tax Liability = ($1,213,800 x 40%) = **$485,520**

33

Learning Objective 4

- Impracticable changes

34

Impracticability

- Do not apply retrospectively if (any one)
  - Cannot determine effects of retrospective application
  - Retrospective application requires assumptions about management's intent in a prior period
  - Retrospective application requires significant estimates that company cannot develop
- Apply change prospectively

35

Learning Objective 5

- Changes in estimates

36

Examples of Estimates

- Uncollectible receivables
- Inventory obsolescence
- Useful lives and salvage values
- Future warranty costs
- Recoverable mineral reserves

37

Changes in Accounting Estimate

- Changes in estimates are normal
- Always reported prospectively
- No retrospective treatment

38

Changes in Accounting Estimate

- Account for changes in estimates in
  - Period of change if change affects that period only
  - Period of change and future periods if change affects both

39

Prospective Change

- No change in previously reported results
- Opening account balances not adjusted and no attempt is made to compensate for prior events
- Change effects current period and future periods only

40

Changes in Estimate: Example 1

- Purchased equipment, $510,000
- Estimated life, 10 years
- Estimated salvage value, $10,000
- Straight-line depreciation
- Depreciation recorded for 7 years
- In 2012 (year 8), revised estimates
  - Revised estimated total life,15 years
  - Revised estimated salvage value, $5,000

41

Changes in Estimate: Example 1

Calculate NBV at date of change in estimate

Calculation of Annual Depreciation	
Equipment cost	$ 510,000
Salvage value	$ 10,000
Total depreciation	$ 500,000
Useful life (original)	10 years
Annual depreciation	**$ 50,000**

Calculation of Net Book Value at end of Year 7	
Equipment cost	$ 510,000
Accumulated depreciation ($50,000 × 7)	350,000
Net book value	**$ 160,000**

42

Changes in Estimate: Example 1

Calculate revised annual depreciation

Calculation of Revised Annual Depreciation	
Equipment cost	$ 510,000
Revised salvage value	$ 5,000
Accumulated deprecation	$ 350,000
Remaining depreciation	$ 155,000
Remaining life (15 − 7 = 8)	8 years
Revised annual depreciation	**$ 19,375**

43

Changes in Estimate: Example 1

Calculate revised annual depreciation

Calculation of Revised Annual Depreciation	
Revised annual depreciation	$ 19,375

Description	Debit	Credit
Depreciation expense	19,375	
Accumulated depreciation		19,375
AJE: Revised depreciation amount after change in estimated life, salvage		

44

Changes in Estimate: Example 2

- Original cost $400,000
- Original life 30 years
- Original salvage value, $100,000

Changes in Estimate: Example 2

- Original cost $400,000
- Original life 30 years
- Original salvage value, $100,000

$$\textbf{Depreciation per year} = \frac{\$400{,}000 - \$100{,}000}{30} = \$10{,}000$$

Description	Debit	Credit
Depreciation Expense	10,000	
Accumulated Depreciation		10,000

Changes in Estimate: Example 2

- After five years of service
  - Improve asset at cost of $500,000
  - Increase salvage value to $250,000
  - Increase total life to 45 years

Description	Debit	Credit
Depreciation Expense	?,???	
Accumulated Depreciation		?,???

Changes in Estimate: Example 2

	Original	Revised
Cost	$400,000	$900,000
Salvage	$100,000	$250,000
Acc dep.	$0	$50,000
Remaining dep.	**$300,000**	**$600,000**
Life	30	45
Remaining life	30	40
Depreciation exp.	**$10,000**	**$15,000**

Changes in Estimate: Example 2

New estimated life	45
− Life consumed	5
Remaining life	**40**

Cost	900,000
− Salvage value	250,000
− Acc. dep.	50,000
Remaining dep.	**600,000**

$$\frac{\text{Remaining depreciation}}{\text{Remaining life}} = \frac{\$600{,}000}{40} = \$15{,}000$$

Changes in Estimate

- Prospective change
  - From today forward
- Not retrospective
  - Prior years not adjusted
- Change begins in current period and continues in future periods
- Called a change in estimate

Disclosures

- Disclosure of changes in accounting estimate made as part of normal operations (bad debt allowances or inventory obsolescence)
- Not required unless changes material

51

Disclosures

- Change in estimate that affects several periods (such as a change in service lives of depreciable assets)
  - Disclose effect on income from continuing operations and related per-share amounts of current period

52

Brief Exercise 22-4

Tedesco Company changed depreciation methods in 2014 from double-declining-balance to straight-line. Depreciation prior to 2014 under double-declining-balance was $94,120, whereas straight-line depreciation prior to 2014 would have been $48,700. Tedesco's depreciable assets (equipment) had a cost of $228,370 with a $40,950 salvage value, and an 6-year remaining useful life at the beginning of 2014.

Account Titles and Explanation	Debit	Credit
Depreciation Expense	15,550	
Accumulated Depreciati		15,550

This is a change in estimate effected by a change in accounting principle.

Cost of depreciable assets	$228,370
Accumulated depreciation	(94,120)
Carrying value at January 1, 2014	134,250
Salvage value	(40,950)
Depreciable base	$93,300

Depreciation in 2014 = $93,300 ÷ 6 = **$15,550**.

53

Brief Exercise 22-5

Sesame Company purchased a computer system (equipment) for $63,990 on January 1, 2013. It was depreciated based on a 6-year life and an $18,390 salvage value. On January 1, 2015, Sesame revised these estimates to a total useful life of 4 years and a salvage value of $11,630.

Account Titles and Explanation	Debit	Credit
Depreciation Expense	18,580	
Accumulated Depreciati		18,580

$$\left(\frac{\$48{,}790^{*} - \$11{,}630}{4 - 2} = \mathbf{\$18{,}580}\right)$$

*Book value before change

Cost	$63,990
Less: Accumulated depreciation	15,200**
	$48,790

**[($63,990 − $18,390) ÷ 6] x 2 = $15,200

54

Brief Exercise 22-9

Roundtree Manufacturing Co. is preparing its year-end financial statements and is considering the accounting for the following items.

Identify whether each of the below items is a change in principle, a change in estimate, or an error.

1. The vice president of sales had indicated that one product line has lost its customer appeal and will be phased out over the next 3 years. Therefore, a decision has been made to lower the estimated lives on related production equipment from the remaining 5 years to 3 years. [Change in estimate]
2. The Hightone Building was converted from a sales office to offices for the Accounting Department at the beginning of this year. Therefore, the expense related to this building will now appear as an administrative expense rather than a selling expense on the current year's income statement. [None of the above]
3. Estimating the lives of new products in the Leisure Products Division has become very difficult because of the highly competitive conditions in this market. Therefore, the practice of deferring and amortizing preproduction costs has been abandoned in favor of expensing such costs as they are incurred. [Change in estimate]

Learning Objective 6

- Identify changes in a reporting entity

Change in Reporting Entity

- Presenting consolidated statements in place of individual companies
- Purchase or sale of subsidiaries in consolidated financial statements
- Changing companies included in combined financial statements
- Changing cost, equity, or consolidation method for subsidiaries, investments

Change in Reporting Entity

- Retrospective
- Restating financial statements of all prior periods presented
- Show financial information for new reporting entity for all periods
- Describe nature of change, reason

Learning Objective 7

- Correction of errors

Types of Accounting Errors

- Mathematical mistakes
- Change estimate not properly made
- Change from non-GAAP accounting method to GAAP method

Correction of Errors

- All material errors must be corrected
- Called prior period adjustments
- Recorded in year error discovered
- Reported in financial statements as adjustment to beginning balance of retained earnings
- Comparative statements
  - Prior statements restated to correct error

61

Correction of Errors: Example 1

- 2013: Error discovered from 2012
- 2012: Failed to record $20,000 depreciation expense on building
- Building is only depreciable asset
- Correctly included depreciation expense in tax return and correctly reported its income taxes payable
  - Straight-line used for both book and tax
  - Tax rate, 40%

62

SELECTRO COMPANY
INCOME STATEMENT
FOR THE YEAR ENDED, DECEMBER 31, 2012

		Without Error		With Error
Income before depreciation expense		$100,000		$100,000
Depreciation expense		20,000		0
Income before income tax		80,000		100,000
Current income tax expense	$32,000		$ 32,000	
Deferred income tax expense	–0–	32,000	8,000	40,000
Net income		$ 48,000		$ 60,000

Entries Company Should Have Made (Without Error)			Entries Company Did Make (With Error)		
Depreciation Expense	20,000		No entry made for depreciation		
Accumulated Depreciation —Buildings		20,000			
Income Tax Expense	32,000		Income Tax Expense	40,000	
Income Taxes Payable		32,000	Deferred Tax Liability		8,000
			Income Taxes Payable		32,000

No book / tax difference

63

Correction of Errors: Example 1

Entries Company Should Have Made (Without Error)			Entries Company Did Make (With Error)		
Depreciation Expense	20,000		No entry made for depreciation		
Accumulated Depreciation —Buildings		20,000			
Income Tax Expense	32,000		Income Tax Expense	40,000	
Income Taxes Payable		32,000	Deferred Tax Liability		8,000
			Income Taxes Payable		32,000

Total debit to expense should have been $52,000; Actual $40,000

Description	Debit	Credit
Retained earnings	12,000	

Correcting journal entry

64

Correction of Errors: Example 1

Entries Company Should Have Made (Without Error)			Entries Company Did Make (With Error)		
Depreciation Expense	20,000		No entry made for depreciation		
Accumulated Depreciation —Buildings		20,000			
Income Tax Expense	32,000		Income Tax Expense	40,000	
Income Taxes Payable		32,000	Deferred Tax Liability		8,000
			Income Taxes Payable		32,000

Credit to Deferred tax liab should not have been made; Reverse

Description	Debit	Credit
Retained earnings	12,000	
Deferred tax liability	8,000	

Correcting journal entry

65

Correction of Errors: Example 1

Entries Company Should Have Made (Without Error)			Entries Company Did Make (With Error)		
Depreciation Expense	20,000		No entry made for depreciation		
Accumulated Depreciation —Buildings		20,000			
Income Tax Expense	32,000		Income Tax Expense	40,000	
Income Taxes Payable		32,000	Deferred Tax Liability		8,000
			Income Taxes Payable		32,000

Entry to credit accumulated depreciation not made; Make it

Description	Debit	Credit
Retained earnings	12,000	
Deferred tax liability	8,000	
Accumulated depreciation		20,000

Correcting journal entry

66

Correction of Errors: Example 1

- Beg R/E January 1, 2013, $350,000
- Net income for 2013, $400,000

SELECTRO COMPANY
RETAINED EARNINGS STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 2013

Retained earnings, January 1, as reported		$350,000
Correction of an error (depreciation)	$20,000	
Less: Applicable income tax reduction	8,000	(12,000)
Retained earnings, January 1, as adjusted		338,000
Add: Net income		400,000
Retained earnings, December 31		$738,000

Correction of Errors: Example 2

- 2012: Discover inventory error in 2011
- 2011: Error occurred
  - Ending inventory overstated, $62,500
  - COGS understated, $62,500
  - N/I before taxes overstated, $62,500
- Tax rate, 20%
- After tax overstatement of N/I, $50,000
  - $62,500 × (1 – 20%) = $50,000

68

Correction of Errors: Example 2

Woods, Inc.
Statement of Retained Earnings
For the Year Ended December 31, 2012

Balance, January 1, as previously reported	$	1,050,000
Prior period adjustment, net of tax		(50,000)
Balance, January 1, as restated		1,000,000
Net income		360,000
Dividends		(300,000)
Balance, December 31	$	1,060,000

69

Brief Exercise 22-6

In 2014, Bailey Corporation discovered that equipment purchased on January 1, 2012, for $44,000 was expensed at that time. The equipment should have been depreciated over 5 years, with no salvage value. The effective tax rate is 30%.

Account Titles and Explanation	Debit	Credit
Equipment	44,000	
Accumulated Depreciati		17,600
Deferred Tax Liability		7,920
Retained Earnings		18,480

Accumulated Depreciation—Equipment = $44,000 x 2/5 = **$17,600**
Deferred Tax Liability = $26,400 x 30% = **$7,920**

$44,000 × 3/5 = $26,4000 (future depreciation expense)

70

Brief Exercise 22-7

At January 1, 2014, Beidler Company reported retained earnings of $2,042,500. In 2014, Beidler discovered that 2013 depreciation expense was understated by $405,300. In 2014, net income was $938,280 and dividends declared were $276,210. The tax rate is 37%.

BEIDLER COMPANY
Retained Earnings Statement
For the Year Ended December 31, 2014

Retained Earnings, January 1	$	2,042,500
Less: Correction of Depreciation Error		255,339
Retained Earnings, January 1, as adjusted		1,787,161
Add: Net Income		938,280
Less: Dividends		276,210
Retained Earnings, December 31	$	2,449,231

Less: Correction of depreciation error, net of tax = $405,300 x (1 – 0.37) = **$255,339**

71

Brief Exercise 22-8

Indicate the effect—Understate, Overstate, No Effect—that each of the following errors has on 2014 net income and 2015 net income.

	2014	2015
(a) Equipment purchased in 2012 was expensed.	Overstated	Overstated
(b) Wages payable were not recorded at 12/31/14.	Overstated	Understated
(c) Equipment purchased in 2014 was expensed.	Understated	Overstated
(d) 2014 ending inventory was overstated.	Overstated	Understated
(e) Patent amortization was not recorded in 2015.	No Effect	Overstated

72

Brief Exercise 22-10

Palmer Co. is evaluating the appropriate accounting for the following items.

Identify whether each of the below items is a change in principle, a change in estimate, or an error.

1. Management has decided to switch from the FIFO inventory valuation method to the LIFO inventory valuation method for all inventories. Change in principle
2. When the year-end physical inventory adjustment was made for the current year, the controller discovered that the prior year's physical inventory sheets for an entire warehouse were mislaid and excluded from last year's count. An error
3. Palmer's Custom Division manufactures large-scale, custom-designed machinery on a contract basis. Management decided to switch from the completed-contract method to the percentage-of-completion method of accounting for long-term contracts. Change in principle

73

Learning Objective 8

- Economic motives for changing

74

Motivations for Change of Accounting Method

- Political costs
- Capital Structure
- Bonus Payments
- Smooth Earnings

75

Learning Objective 9

- Analyze effect of errors

76

Error Analysis

- Errors are prior-period adjustments
- Report in current year as adjustments to beginning balance of Retained Earnings
- Answer three questions
  - What type of error is involved?
  - What entries needed to correct for error?
  - After discovery of error, how are financial statements to be restated?

77

Balance Sheet Errors

- Balance sheet errors affect only presentation of an asset, liability, or stockholders' equity account
- Current year error: Reclassify item to its proper position
- Prior year error: Restate balance sheet of prior year for comparative purposes

78

Income Statement Errors

- Improper classification of revenues or expenses
- Current year error: Reclassify item to its proper position
- Prior year error: Restate income statement of prior year for comparative purposes

79

Counterbalancing Errors

- Counterbalancing errors will be offset or corrected over two periods
- Restatement necessary even if a correcting journal entry is not required

80

Counterbalancing Errors

- If company has closed books
  - If error already counterbalanced, no entry
  - If error is not counterbalanced, make entry to adjust current balance of R/E

81

Counterbalancing Errors

- If company has not closed books
  - If error already counterbalanced, make entry to correct error in current period and to adjust beginning balance of R/E
  - If error not yet counterbalanced, make entry to adjust beginning balance of R/E

82

Non-Counterbalancing Errors

- Not offset in next accounting period
- Companies must make correcting entries, even if they have closed books

83

Error Analysis: Example 1

- Selected accounts as of Dec 31, 2012
- AJEs required at year-end

Account	Debit	Credit
Supplies	$2,500	
Salaries payable		$1,500
Interest receivable	5,100	
Prepaid insurance	90,000	
Unearned rent		0
Interest payable		15,000

84

Account	Debit	Credit
Supplies	$2,500	

Supplies on hand at year-end, $1,100

Description	Debit	Credit
Supplies expense	1,400	
Supplies		1,400
AJE if books not closed		

Description	Debit	Credit
Retained earnings	1,400	
Supplies		1,400
AJE if books closed		

85

Account	Debit	Credit
Salaries payable		$1,500

Accrued salaries at year-end, $4,400

Description	Debit	Credit
Salaries expense	2,900	
Salaries payable		2,900
AJE if books not closed		

Description	Debit	Credit
Retained earnings	2,900	
Salaries payable		2,900
AJE if books closed		

86

Account	Debit	Credit
Interest receivable	5,100	

Accrued interest at year-end, $4,350

Description	Debit	Credit
Interest revenue	750	
Interest receivable		750
AJE if books not closed		

Description	Debit	Credit
Retained earnings	750	
Interest receivable		750
AJE if books closed		

87

Account	Debit	Credit
Prepaid insurance	90,000	

Prepaid insurance at year-end, $65,000

Description	Debit	Credit
Insurance expense	25,000	
Prepaid insurance		25,000
AJE if books not closed		

Description	Debit	Credit
Retained earnings	25,000	
Prepaid insurance		25,000
AJE if books closed		

88

Account	Debit	Credit
Unearned rent		0

Tenant paid $24,000 for two years rent on Jan 1, 2012; Entire amount credited to income

Description	Debit	Credit
Rental income	12,000	
Unearned rent		12,000
AJE if books not closed		

Description	Debit	Credit
Retained earnings	12,000	
Unearned rent		12,000
AJE if books closed		

89

Depreciation for 2012 recorded as $5,000; Should have been $50,000

Description	Debit	Credit
Depreciation expense	45,000	
Accumulated depreciation		45,000
AJE if books not closed		

Description	Debit	Credit
Retained earnings	45,000	
Accumulated depreciation		45,000
AJE if books closed		

90