Reporting Accounting Changes and Error Analysis

Chapter 22

Intermediate Accounting
12th Edition
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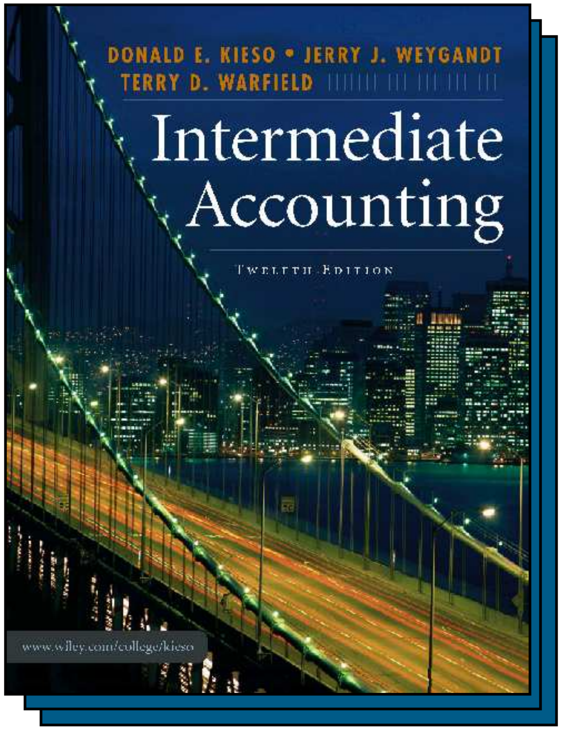

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Learning Objectives

1. Identify the types of accounting changes.
2. Describe the accounting for changes in accounting principles.
3. Understand how to account for retrospective accounting changes.
4. Understand how to account for impracticable changes.
5. Describe the accounting for changes in estimates.
6. Identify changes in a reporting entity.
7. Describe the accounting for correction of errors.
8. Identify economic motives for changing accounting methods.
9. Analyze the effect of errors.

Accounting Changes and Error Analysis

Accounting Changes

- Changes in accounting principle
- Changes in accounting estimate
- Reporting a change in entity
- Reporting a correction of an error
- Summary
- Motivations for change of method

Error Analysis

- Balance sheet errors
- Income statement errors
- Balance sheet and income statement effects
- Comprehensive example
- Preparation of statements with error corrections

Accounting Changes

Accounting alternatives:

1) Diminish the comparability of financial information.
2) Obscure useful historical trend data.

Types of Accounting Changes:

- Change in Accounting Principle.
- Changes in Accounting Estimate.
- Change in Reporting Entity.

Errors are not considered an accounting change.

Changes in Accounting Principle

A **change** from one generally accepted accounting principle to another. Examples include:

- Average cost to LIFO.
- Completed-contract to percentage-of-completion.

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

LO 2 Describe the accounting for changes in accounting principles.

Changes in Accounting Principle

Three approaches for reporting changes:

1) Currently (cumulative effect).
2) Retrospectively.
3) Prospectively (in the future).

FASB requires use of the retrospective approach.

Changes in Accounting Principle

Retrospective Accounting Change Approach

Company reporting the change

1) adjusts its financial statements for each prior period presented to the same basis as the new accounting principle.

2) adjusts the carrying amounts of assets and liabilities as of the beginning of the first year presented, plus the opening balance of retained earnings.

LO 3 Understand how to account for retrospective accounting changes.

Retrospective Change Example

Example (Retrospective Change) Buildmore Construction Company used the completed contract method to account for long-term construction contracts for financial accounting and tax purposes in 2007, its first year of operations. In 2008, the company decided to change to the percentage-of-completion method for financial accounting purposes. Income before long-term contracts and taxes in 2007 and 2008 was $80,000 and $100,000. The tax rate is 40% and the company will continue to use the completed contract method for tax purposes.

LO 3 Understand how to account for retrospective accounting changes.

Retrospective Change Example

Example Income from Long-Term Contracts

Date	Percentage-of-Completion	Completed Contract	Difference	40% Tax Effect	Net of Tax
2007	$ 40,000	$ 25,000	$ 15,000	$ 6,000	$ 9,000
2008	60,000	55,000	5,000	2,000	3,000

Journal entry

2008	Construction in progress	15,000	
	Deferred tax liability		6,000
	Retained earnings		9,000

LO 3 Understand how to account for retrospective accounting changes.

Retrospective Change Example

Example Comparative Income Statements

	2008	Restated 2007	Previous 2007
Income before LT contracts	$ 100,000	$ 80,000	$ 80,000
Income from LT contracts	60,000	40,000	25,000
Income before tax	160,000	120,000	105,000
Income tax	64,000	48,000	42,000
Net income	$ 96,000	$ 72,000	$ 63,000

LO 3 Understand how to account for retrospective accounting changes.

Retrospective Change Example

Example Retained Earnings Statement

	2008	Restated 2007	Previous 2007
Beg. balance previously reported	$ 63,000	$ -	$ -
Effect of accounting change	9,000	-	-
Beg. balance restated	72,000	-	-
Net income	96,000	72,000	63,000
Ending balance	$ 168,000	$ 72,000	$ 63,000

LO 3 Understand how to account for retrospective accounting changes.

Changes in Accounting Principle

Impracticability

Companies should not use retrospective application if one of the following conditions exists:

1. Company cannot determine the effects of the retrospective application.
2. Retrospective application requires assumptions about management's intent in a prior period.
3. Retrospective application requires significant estimates that the company cannot develop.

If any of the above conditions exists, the company **prospectively** applies the new accounting principle.

LO 4 Understand how to account for impracticable changes.

Changes in Accounting Estimate

The following items require estimates.

1. Uncollectible receivables.
2. Inventory obsolescence.
3. Useful lives and salvage values of assets.
4. Periods benefited by deferred costs.
5. Liabilities for warranty costs and income taxes.
6. Recoverable mineral reserves.
7. Change in depreciation methods.

Companies report prospectively changes in accounting estimates.

Change in Estimate Example

Arcadia HS, purchased equipment for $510,000 which was estimated to have a useful life of 10 years with a salvage value of $10,000 at the end of that time. Depreciation has been recorded for 7 years on a straight-line basis. In 2005 (year 8), it is determined that the total estimated life should be 15 years with a salvage value of $5,000 at the end of that time.

Required:

- What is the journal entry to correct the prior years' depreciation?
- Calculate the depreciation expense for 2005.

No Entry Required

Change in Estimate Example

After 7 years

Equipment cost	$510,000
Salvage value	- 10,000
Depreciable base	500,000
Useful life (original)	10 years
Annual depreciation	$ 50,000

× 7 years = $350,000

First, establish NBV at date of change in estimate.

Balance Sheet (Dec. 31, 2004)

Fixed Assets:

Equipment	$510,000
Accumulated depreciation	350,000
Net book value (NBV)	$160,000

LO 5 Describe the accounting for changes in estimates.

Change in Estimate Example

After 7 years

Net book value	$160,000
Salvage value (new)	5,000
Depreciable base	155,000
Useful life remaining	8 years
Annual depreciation	$ 19,375

Second, calculate depreciation expense for 2005.

Journal entry for 2005

Depreciation expense	19,375	
Accumulated depreciation		19,375

LO 5 Describe the accounting for changes in estimates.

Reporting a Change in Entity

Examples of a change in reporting entity are:

1. Presenting consolidated statements in place of statements of individual companies.
2. Changing specific subsidiaries that constitute the group of companies for which the entity presents consolidated financial statements.
3. Changing the companies included in combined financial statements.
4. Changing the cost, equity, or consolidation method of accounting for subsidiaries and investments.

Reported by changing the financial statements of all prior periods presented.

LO 6 Identify changes in a reporting entity.

Reporting a Correction of an Error

Accounting errors include the following types:

1. A change from an accounting principle that is **not** generally accepted to an accounting principle that is acceptable.
2. Mathematical mistakes.
3. Changes in estimates that occur because a company did not prepare the estimates in good faith.
4. Failure to accrue or defer certain expenses or revenues.
5. Misuse of facts.
6. Incorrect classification of a cost as an expense instead of an asset, and vice versa.

Reporting a Correction of an Error

- All material errors must be corrected.
- Record **corrections of errors** from prior periods as an adjustment to the beginning balance of retained earnings in the current period.
- Such corrections are called **prior period adjustments**.
- For comparative statements, a company should restate the prior statements affected, to correct for the error.

Retained Earnings Statement

Woods, Inc.
Statement of Retained Earnings
For the Year Ended December 31, 2007

Balance, January 1	$	1,050,000
Net income		360,000
Dividends		(300,000)
Balance, December 31	$	1,110,000

Before issuing the report for the year ended December 31, 2007, you discover a $62,500 error that caused the 2006 inventory to be overstated (overstated inventory caused COGS to be lower and thus net income to be higher in 2006). Would this discovery have any impact on the reporting of the Statement of Retained Earnings for 2007? Assume a 20% tax rate.

LO 7 Describe the accounting for correction of errors.

Retained Earnings Statement

Woods, Inc.
Statement of Retained Earnings
For the Year Ended December 31, 2007

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

LO 7 Describe the accounting for correction of errors.

Summary of Accounting Changes and Corrections of Errors

- Changes in accounting principle are appropriate **only** when a company demonstrates that the newly adopted generally accepted accounting principle is **preferable** to the existing one.
- Companies and accountants determine preferability on the basis of whether the new principle constitutes an **improvement in financial reporting**, not on the basis of the income tax effect alone.

Motivations for Change of Accounting Method

Some reasons are as follows:

1. Political costs.
2. Capital Structure.
3. Bonus Payments.
4. Smooth Earnings.

LO 8 Identify economic motives for changing accounting methods.

Section 2 – Error Analysis

Companies must answer three questions:

1. What type of error is involved?
2. What entries are needed to correct for the error?
3. After discovery of the error, how are financial statements to be restated?

Companies treat errors as **prior-period adjustments** and report them in the current year as adjustments to the beginning balance of Retained Earnings.

Section 2 – Error Analysis

Balance Sheet Errors

Balance sheet errors affect only the presentation of an asset, liability, or stockholders' equity account.

When the error is discovered in the error year, the company reclassifies the item to its proper position.

If the error is discovered in a prior year, the company should restate the balance sheet of the prior year for comparative purposes.

Income Statement Errors

Improper classification of revenues or expenses.

A company must make a reclassification entry when it discovers the error in the error year.

If the error is discovered in a prior year, the company should restate the income statement of the prior year for comparative purposes.

Section 2 – Error Analysis

Balance Sheet and Income Statement Errors

Errors affecting both balance sheet and income statement.

This type of error classified as:

1. Counterbalancing errors
2. Noncounterbalancing errors

Section 2 – Error Analysis

Counterbalancing Errors

Will be offset or corrected over two periods.

If company has closed the books:

a. If the error is already counterbalanced, no entry is necessary.

b. If the error is not yet counterbalanced, make entry to adjust the present balance of retained earnings.

For comparative purposes, restatement is necessary even if a correcting journal entry is not required.

Section 2 – Error Analysis

Counterbalancing Errors

Will be offset or corrected over two periods.

If company has not closed the books:

a. If error already counterbalanced, make entry to correct the error in the current period and to adjust the beginning balance of Retained Earnings.

b. If error not yet counterbalanced, make entry to adjust the beginning balance of Retained Earnings.

Section 2 – Error Analysis

Noncounterbalancing Errors

Not offset in the next accounting period.

Companies must make correcting entries, even if they have closed the books.

Error Analysis Example

E22-19 (Error Analysis; Correcting Entries) A partial trial balance of Julie Hartsack Corporation is as follows on December 31, 2008.

	Dr.	Cr.
Supplies on hand	$ 2,700	
Accured salaries and wages		$ 1,500
Interest receivable	5,100	
Prepaid insurance	90,000	
Unearned rent		0
Accured interest payable		15,000

Instructions

(a) Assuming that the books have not been closed, what are the adjusting entries necessary at December 31, 2008?

LO 9 Analyze the effect of errors.

Error Analysis Example

(a) Assuming that the books have not been closed, what are the adjusting entries necessary at December 31, 2008?

1. A physical count of supplies on hand on December 31, 2008, totaled $1,100.

Supplies expense	1,600	
Supplies on hand		1,600

2. Accrued salaries and wages on December 31, 2008, amounted to $4,400.

Salaries and wages expense	2,900	
Accured salaries and wages		2,900

Error Analysis Example

(a) Assuming that the books have not been closed, what are the adjusting entries necessary at December 31, 2008?

3. Accrued interest on investments amounts to $4,350 on December 31, 2008.

Interest revenue	750	
Interest receivable		750

4. The unexpired portions of the insurance policies totaled $65,000 as of December 31, 2008.

Insurance expense	25,000	
Prepaid insurance		25,000

Error Analysis Example

(a) Assuming that the books have not been closed, what are the adjusting entries necessary at December 31, 2008?

5. $28,000 was received on January 1, 2008 for the rent of a building for both 2008 and 2009. The entire amount was credited to rental income.

Rental income	14,000	
Unearned rent		14,000

6. Depreciation for the year was erroneously recorded as $5,000 rather than the correct figure of $50,000.

Depreciation expense	45,000	
Accumulated depreciation		45,000

Error Analysis Example

E22-19 (Error Analysis; Correcting Entries) A partial trial balance of Julie Hartsack Corporation is as follows on December 31, 2008.

	Dr.	Cr.
Supplies on hand	$ 2,700	
Accured salaries and wages		$ 1,500
Interest receivable	5,100	
Prepaid insurance	90,000	
Unearned rent		0
Accured interest payable		15,000

Instructions

(b) Assuming that the books have been closed, what are the adjusting entries necessary at December 31, 2008?

LO 9 Analyze the effect of errors.

Error Analysis Example

(b) Assuming that the books have been closed, what are the adjusting entries necessary at December 31, 2008?

1. A physical count of supplies on hand on December 31, 2008, totaled $1,100.

Retained earnings	1,600	
Supplies on hand		1,600

2. Accrued salaries and wages on December 31, 2008, amounted to $4,400.

Retained earnings	2,900	
Accured salaries and wages		2,900

LO 9 Analyze the effect of errors.

Error Analysis Example

(b) Assuming that the books have been closed, what are the adjusting entries necessary at December 31, 2008?

3. Accrued interest on investments amounts to $4,350 on December 31, 2008.

Retained earnings	750	
Interest receivable		750

4. The unexpired portions of the insurance policies totaled $65,000 as of December 31, 2008.

Retained earnings	25,000	
Prepaid insurance		25,000

Error Analysis Example

(b) Assuming that the books have been closed, what are the adjusting entries necessary at December 31, 2008?

5. $28,000 was received on January 1, 2008 for the rent of a building for both 2008 and 2009. The entire amount was credited to rental income.

Retained earnings	14,000	
Unearned rent		14,000

6. Depreciation for the year was erroneously recorded as $5,000 rather than the correct figure of $50,000.

Retained earnings	45,000	
Accumulated depreciation		45,000

LO 9 Analyze the effect of errors.

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