

CHAPTER 22

Accounting Changes and Error Analysis

ASSIGNMENT CLASSIFICATION TABLE (BY TOPIC)

Topics	Questions	Brief Exercises	Exercises	Problems	Concepts for Analysis
1. Differences between change in principle, change in estimate, change in entity, errors.	4, 6, 7, 8, 9, 12, 13, 15			3	1, 2, 3, 4
2. Accounting changes:					
a. Comprehensive.				3, 6, 7	1, 2, 4, 5
b. Changes in estimate, changes in depreciation methods.	9	4, 5, 9	2, 3, 4, 6, 7, 8, 9, 10, 11, 12, 16, 17	1, 2, 4, 6, 7	1, 2, 3, 4, 6
c. Changes in accounting for long-term construction contracts.	2, 10	1, 2, 10	1, 7, 13		1, 2
d. Change from FIFO to average cost.			2, 8, 14		3
e. Change from FIFO to LIFO.	2, 11	10	4, 9		1, 2
f. Change from LIFO.		3	2, 3, 5, 8	2, 5	
g. Miscellaneous.	1, 3, 4, 5, 8	8, 9, 10			1, 5
3. Correction of an error.					
a. Comprehensive.	14, 17, 19	8, 9, 10	8, 15, 16, 19, 20, 21	3, 6, 7, 8, 9, 10	2, 4
b. Depreciation.	18, 21	6, 7	1, 9, 17, 18	1, 6	
c. Inventory.	9, 16, 20	10	7, 17	2, 10	1, 2
*4. Changes between fair value and equity methods.		11, 12	22, 23	11, 12	

*This material is dealt with in an Appendix to the chapter.

ASSIGNMENT CLASSIFICATION TABLE (BY LEARNING OBJECTIVE)

Learning Objectives	Brief Exercises	Exercises	Problems
1. Identify the types of accounting changes.			
2. Describe the accounting for changes in accounting principles.			1
3. Understand how to account for retrospective accounting changes.	1, 2, 3, 9, 10	1, 2, 3, 4, 5, 8, 13, 14	2, 3, 5
4. Understand how to account for impracticable changes.		2	
5. Describe the accounting for changes of estimates.	4, 5, 9, 10	6, 7, 8, 9, 10, 11, 12	1, 2, 3, 4, 6
6. Identify changes in a reporting entity.			
7. Describe the accounting for correction of errors.	6, 7, 8, 9, 10	7, 8, 9, 10, 15, 16, 17, 18, 19, 20, 21	1, 2, 3, 6, 7, 8, 9, 10
8. Identify economic motives for changing accounting methods.			
9. Analyze the effect of errors.		18, 19, 20, 21	6, 7, 8, 9, 10
*10. Make the computations and prepare the entries necessary to record a change from or to the equity method of accounting.	11, 12	22, 23	11, 12

ASSIGNMENT CHARACTERISTICS TABLE

Item	Description	Level of Difficulty	Time (minutes)
E22-1	Change in principle—long-term contracts.	Moderate	10–15
E22-2	Change in principle—inventory.	Moderate	10–15
E22-3	Accounting change.	Difficult	25–30
E22-4	Accounting change.	Difficult	25–30
E22-5	Accounting change.	Difficult	30–35
E22-6	Accounting changes—depreciation.	Difficult	30–35
E22-7	Change in estimate and error; financial statements.	Moderate	25–30
E22-8	Accounting changes and errors.	Simple	5–10
E22-9	Error and change in estimate—depreciation.	Simple	15–20
E22-10	Depreciation changes.	Moderate	20–25
E22-11	Change in estimate—depreciation.	Simple	10–15
E22-12	Change in estimate—depreciation.	Simple	20–25
E22-13	Change in principle—long-term contracts.	Simple	10–15
E22-14	Various changes in principle—inventory methods.	Moderate	20–35
E22-15	Error correction entries.	Simple	15–20
E22-16	Error analysis and correcting entry.	Simple	10–15
E22-17	Error analysis and correcting entry.	Simple	10–15
E22-18	Error analysis.	Moderate	25–30
E22-19	Error analysis; correcting entries.	Simple	20–25
E22-20	Error analysis.	Moderate	20–25
E22-21	Error analysis.	Moderate	10–15
*E22-22	Change from fair value to equity.	Complex	25–30
*E22-23	Change from equity to fair value.	Moderate	15–20
P22-1	Change in estimate and error correction.	Moderate	30–35
P22-2	Comprehensive accounting change and error analysis problem.	Complex	30–40
P22-3	Error corrections and accounting changes.	Complex	30–40
P22-4	Accounting changes.	Moderate	40–50
P22-5	Change in principle—inventory.	Moderate	30–35
P22-6	Accounting changes and error analysis.	Moderate	25–30
P22-7	Error corrections.	Moderate	25–30
P22-8	Comprehensive error analysis.	Difficult	30–35
P22-9	Error analysis.	Moderate	20–25
P22-10	Error analysis and correcting entries.	Complex	50–60
*P22-11	Fair value to equity method with goodwill.	Moderate	20–25
*P22-12	Change from fair value to equity method.	Moderate	20–25
C22-1	Analysis of various accounting changes and errors.	Moderate	25–35
C22-2	Analysis of various accounting changes and errors.	Moderate	20–30
C22-3	Analysis of three accounting changes and errors.	Moderate	30–35
C22-4	Analysis of various accounting changes and errors.	Moderate	20–30
C22-5	Change in principle, estimate.	Moderate	20–30
C22-6	Change in estimates, ethics.	Moderate	20–30

ANSWERS TO QUESTIONS

1. The major reasons are:
 - (1) Desire to show better profit picture.
 - (2) Desire to increase cash flows through reduction in income taxes.
 - (3) Requirement by Financial Accounting Standards Board to change accounting methods.
 - (4) Desire to follow industry practices.
 - (5) Desire to show a better measure of the company's income.
2.
 - (a) Change in accounting principle; retrospective application is generally not made because it is impracticable to determine the effect of the change on prior years. The FIFO inventory amount is therefore generally the beginning inventory in the current period.
 - (b) Correction of an error and therefore prior period adjustment; adjust the beginning balance of retained earnings.
 - (c) Increase income for litigation settlement.
 - (d) Change in accounting estimate; currently and prospectively. Part of operating section of income statement.
 - (e) Charge to expense.
 - (f) Change in accounting principle; retrospective application to prior period financial statements.
3. The three approaches suggested for reporting changes in accounting principles are:
 - (a) Currently—the cumulative effect of the change is reported in the current year's income as a special item.
 - (b) Retrospectively—the cumulative effect of the change is reported as an adjustment to retained earnings. The prior year's statements are changed on a basis consistent with the newly adopted principle.
 - (c) Prospectively—no adjustment is made for the cumulative effect of the change. Previously reported results remain unchanged. The change shall be accounted for in the period of the change and in subsequent periods if the change affects future periods.
4. The FASB believes that the retrospective approach provides financial statement users the most useful information. Under this approach, the prior statements are changed on a basis consistent with the newly adopted standard; any cumulative effect of the change for prior periods is recorded as an adjustment to the beginning balance of retained earnings of the earliest period reported.
5. The indirect effect of a change in accounting principle reflects any changes in current or future cash flows resulting from a change in accounting principle that is applied retrospectively. An example is the change in payments to a profit-sharing plan that is based on reported net income. Indirect effects are not included in the retrospective application, but instead are reported in the period in which the accounting change occurs (current period).
6. A change in an estimate is simply a change in the way an individual perceives the realizability of an asset or liability. Examples of changes in estimate are: (1) change in the realizability of trade receivables, (2) revisions of estimated lives, (3) changes in estimates of warranty costs, and (4) change in estimate of deferred charges or credits. A change in accounting estimate effected by a change in accounting principle occurs when a change in accounting estimate is inseparable from the effect of a related change in accounting principle. An example would be switching from capitalizing advertising expenditures to expensing them if the future benefit of the expenditures can no longer be estimated with reasonable certainty.
7. This is an example of a situation in which it is difficult to differentiate between a change in accounting principle and a change in estimate. In such a situation, the change should be considered a change in estimate, and accordingly, should be handled currently and prospectively. Thus, all costs presently capitalized and viewed as providing doubtful future values should be expensed immediately, and costs currently incurred should also be expensed immediately.

Questions Chapter 22 (Continued)

8.
 - (a) Charge to expense—possibly separately disclosed.
 - (b) Change in estimate that is effected by a change in accounting principle—currently and prospectively.
 - (c) Charge to expense—possibly separately disclosed.
 - (d) Correction of an error and reported as a prior period adjustment—adjust the beginning balance of retained earnings.
 - (e) Change in accounting principle—retrospective application to all affected prior-period financial statements.
 - (f) Change in accounting estimate—currently and prospectively.
9. This change is to be handled as a correction of an error. As such, the portion of the change attributable to prior periods (\$33,000) should be reported as an adjustment to the beginning balance of retained earnings in the 2007 financial statements. If statements for previous years are presented for comparative purposes, these statements should be restated to correct for the error. The remainder of the inventory value (\$29,000) should be reported in the 2007 statements as a reduction of materials cost.
10. Preferability is a difficult concept to apply. The problem is that there are no basic objectives to indicate which is the most preferable method, assuming a selection between two generally accepted accounting practices is possible, such as completed contract and percentage of completion. If a FASB standard creates a new principle or expresses preference for or rejects a specific accounting principle, a change is considered clearly acceptable. A more appropriate matching of revenues and expenses is often given as the justification for a change in accounting principle.
11. When a company changes to the LIFO method, the base-year inventory for all subsequent LIFO calculations is the beginning inventory in the year the method is adopted. This assumes that prior years' income is not changed because it would be too impractical to do so. The only adjustment necessary may be to adjust the beginning inventory from a lower of cost or market approach to a cost basis.
12. Where individual company statements were reported in prior years and consolidated financial statements are to be prepared this year, the following reporting and disclosure practices should be implemented:
 - (1) The financial statements of all prior periods presented should be restated to show the financial information for the new reporting entity for all periods.
 - (2) The financial statements of the year in which the change in reporting entity is made should describe the nature of the change and the reason for it.
 - (3) The effect of the change on income before extraordinary items, net income, and earnings per share amounts should be disclosed for all periods presented.
13. This change represents a change in reporting entity. This type of change should be reported by restating the financial statements of all prior periods presented to show the financial information for the new reporting entity for all periods. The financial statements of the year in which the change in reporting entity is made should describe the nature of the change and the reason for it. The effect of the change on income before extraordinary items, net income, and earnings per share amounts should be disclosed for all periods presented.
14. Counterbalancing errors are errors that will be offset or corrected over two periods. Non-counterbalancing errors are errors that are not offset in the next accounting period. An example of a counterbalancing error is the failure to record accrued wages or prepaid expenses. Failure to capitalize equipment and record depreciation is an example of a non-counterbalancing error.

Questions Chapter 22 (Continued)

15. A correction of an error in previously issued financial statements should be handled as a prior-period adjustment. Thus, such an error should be reported in the year that it is discovered as an adjustment to the beginning balance of retained earnings. And, if comparative statements are presented, the prior periods affected by the error should be restated. The disclosures need not be repeated in the financial statements of subsequent periods.

As an illustration, assume that credit sales of \$40,000 were inadvertently overlooked at the end of 2007. When the error was discovered in a subsequent period, the appropriate entry to record the correction of the error would have been (ignoring income tax effects):

Accounts Receivable	40,000	
Retained Earnings.....		40,000

16. This change represents a change from an accounting principle that is **not** generally accepted to an accounting principle that is acceptable. As such, this change should be handled as a correction of an error. Thus, in the 2008 statements, the cumulative effect of the change should be reported as an adjustment to the beginning balance of retained earnings. If 2007 statements are presented for comparative purposes, these statements should be restated to correct for the accounting error.

17. Retained earnings is correctly stated at December 31, 2008. Failure to accrue salaries in earlier years is a counterbalancing error that has no effect on 2008 ending retained earnings.

18. December 31, 2008

Machinery.....	8,000	
Accumulated Depreciation—Machinery.....		800
Retained Earnings.....		7,200
(To correct for the error of expensing installation costs on machinery acquired in January, 2007)		
Depreciation Expense [(\$38,000 – \$3,800) ÷ 20]	1,710	
Accumulated Depreciation—Machinery.....		1,710
(To record depreciation on machinery for 2008 based on a 20-year useful life)		

19. The amortization error decreases net income by \$2,850 in 2007. Interest expense related to the discount should have been charged for \$150, but was charged for \$3,000. The entry to correct for this error is as follows:

Discount on Bonds Payable	2,850	
Interest Expense.....		2,850

The entry to record accrued interest on the \$100,000 of principal at 11% for 6 months is:

Interest Expense.....	5,500	
Interest Payable.....		5,500

20. This error has no effect on net income because both purchases and inventory were understated. The entry to correct for this error, assuming a periodic inventory system, is:

Purchases	13,000	
Accounts Payable.....		13,000

21. This error increases net income by \$1,800 in 2007. Depreciation should have been charged to net income. The entry to correct for this error is as follows:

Depreciation Expense.....	1,800	
Accumulated Depreciation—Equipment.....		1,800

SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 22-1

Construction in Process (\$128,000 – \$80,000).....	48,000	
Deferred Tax Liability		
[(\$128,000 – \$80,000) X 35%]		16,800
Retained Earnings.....		31,200

BRIEF EXERCISE 22-2

Difference in profit sharing expense—prior years		\$128,000
Pre-tax income—percentage of completion		80,000
Pre-tax income—completed contract		<u>48,000</u>
		X 1%
Indirect effect		<u>\$ 480</u>

The indirect effect from prior years will be reported as a profit sharing expense for year (2008).

BRIEF EXERCISE 22-3

Inventory	1,000,000	
Deferred Tax Liability (\$1,000,000 X 40%)		400,000
Retained Earnings.....		600,000

BRIEF EXERCISE 22-4

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

Cost of depreciable assets.....		\$250,000
Accumulated depreciation		<u>(90,000)</u>
Carrying value at January 1, 2008.....		160,000
Salvage value.....		<u>(50,000)</u>
Depreciable base		<u>\$110,000</u>

Depreciation in 2008 = \$110,000 ÷ 8 = \$13,750.

Depreciation Expense.....	13,750	
Accumulated Depreciation.....		13,750

BRIEF EXERCISE 22-5

Depreciation Expense	19,000	
Accumulated Depreciation		19,000
$\left(\frac{\$48,000 - \$10,000}{4 - 2} = \$19,000 \right)$		

BRIEF EXERCISE 22-6

Equipment	75,000	
Accumulated Depreciation		30,000
Deferred Tax Liability		13,500
Retained Earnings		31,500
(\$30,000 = \$75,000 X 2/5; \$13,500 = \$45,000 X 30%)		

BRIEF EXERCISE 22-7

WILLIAM R. MONAT COMPANY
Retained Earnings Statement
For the Year Ended December 31, 2008

Retained earnings, January 1, as previously reported.....	\$2,000,000
Less: Correction of depreciation error, net of tax	<u>300,000</u>
Retained earnings, January 1, as adjusted	1,700,000
Add: Net income	900,000
Less: Dividends.....	<u>250,000</u>
Retained earnings, January 31	<u><u>\$2,350,000</u></u>

BRIEF EXERCISE 22-8

	<u>2007</u>	<u>2008</u>
a.	Overstated	Understated
b.	Overstated	Overstated
c.	Understated	Overstated
d.	Overstated	Understated
e.	No effect	Overstated

BRIEF EXERCISE 22-9

- 1. The change to a three-year remaining life for the purpose of computing depreciation on production equipment is a change in estimate due to a change in conditions.**
- 2. The change to expensing preproduction costs (writing the costs off in one year as opposed to several years) is a change in estimate due to a change in conditions.**
- 3. This is an expense classification change arising from a change in the use of the building for a different purpose. Thus, it is not a change in principle, a change in estimate, or an error.**

BRIEF EXERCISE 22-10

- 1. This oversight is a mistake that should be corrected. Such a correction is considered a change due to error.**
- 2. Both FIFO and LIFO are generally accepted accounting principles; thus, is a change in accounting principle.**
- 3. Both the completed-contract method and the percentage-of-completion method are generally accepted accounting principles; thus, such a change is a change in accounting principle.**

***BRIEF EXERCISE 22-11**

Cash	7,600	
Available-for-Sale Securities		1,200
Dividend Revenue		6,400

***BRIEF EXERCISE 22-12**

Investment in Knight Stock	478,000	
Cash		445,000
Retained Earnings		33,000
Investment in Knight Stock	185,000	
Available-for-Sale Securities.....		185,000
Unrealized Holding Gain or Loss—Equity.....	34,000	
Securities Fair Value Adjustment		
(Available-for-Sale)		34,000

SOLUTIONS TO EXERCISES

EXERCISE 22-1 (10–15 minutes)

- (a) The net income to be reported in 2008, using the retrospective approach, would be computed as follows:

Income before income tax	\$700,000
Income tax (35% X \$700,000)	<u>245,000</u>
Net income	<u>\$455,000</u>

- (b) Construction in Process 190,000
 Deferred Tax Liability (\$190,000 X 35%) 66,500
 Retained Earnings 123,500*

*(\$190,000 X 65% = \$123,500)

EXERCISE 22-2 (10–15 minutes)

- (a) Inventory..... 14,000*
 Retained Earnings..... 14,000

*(\$19,000 + \$23,000 + \$25,000) – (\$15,000 + \$18,000 + \$20,000)

- (b) Net Income (FIFO) 2005 \$19,000
 2006 23,000
 2007 25,000

- (c) Inventory..... 24,000*
 Retained Earnings..... 24,000

*(\$19,000 + \$23,000 + \$25,000) – (\$12,000 + \$14,000 + \$17,000)

EXERCISE 22-3 (25–30 minutes)

**(a) TAVERAS CO.
Income Statement
For the Year Ended December 31**

	<u>LIFO</u>		
	<u>2005</u>	<u>2006</u>	<u>2007</u>
Sales	\$3,000	\$3,000	\$3,000
Cost of goods sold.....	800	1,000	1,130
Operating expenses	<u>1,000</u>	<u>1,000</u>	<u>1,000</u>
Net income.....	<u>\$1,200</u>	<u>\$1,000</u>	<u>\$ 870</u>

**Income Statement
For the Year Ended December 31**

	<u>FIFO</u>		
	<u>2005</u>	<u>2006</u>	<u>2007</u>
Sales	\$3,000	\$3,000	\$3,000
Cost of goods sold.....	820	940	1,100
Operating expenses	<u>1,000</u>	<u>1,000</u>	<u>1,000</u>
Net income.....	<u>\$1,180</u>	<u>\$1,060</u>	<u>\$ 900</u>

**(b) TAVERAS CO.
Income Statement
For the Year Ended December 31**

	<u>2007</u>	<u>2006</u>
		As adjusted (Note A)
Sales	\$3,000	\$3,000
Cost of goods sold.....	1,100	940
Operating expenses	<u>1,000</u>	<u>1,000</u>
Net income.....	<u>\$ 900</u>	<u>\$1,060</u>

EXERCISE 22-3 (Continued)

(c) Note A:

Change in Method of Accounting for Inventory Valuation

On January 1, 2007, Taveras elected to change its method of valuing its inventory to the FIFO method, whereas in all prior years inventory was valued using the LIFO method. The new method of accounting for inventory was adopted because it better reflects the current cost of the inventory on the balance sheet and comparative financial statements of prior years have been adjusted to apply the new method retrospectively. The following financial statement line items for fiscal years 2007 and 2006 were affected by the change in accounting principle.

	<u>2007</u>			<u>2006</u>		
	<u>LIFO</u>	<u>FIFO</u>	<u>Difference</u>	<u>LIFO</u>	<u>FIFO</u>	<u>Difference</u>
<u>Balance Sheet</u>						
Inventory	\$ 320	\$ 390	\$70	\$ 200	\$ 240	\$40
Retained Earnings	3,070	3,140	70	2,200	2,240	40
<u>Income Statement</u>						
Cost of Goods Sold	\$1,130	\$1,100	\$30	\$1,000	\$940	\$60
Net Income	870	900	30	1,000	1,060	60
<u>Statement of Cash Flows</u>						
(no effect)						

(d) Retained earnings statements after retrospective application.

	<u>2007</u>	<u>2006</u>
Retained earnings, January 1, as reported		\$1,200
Less: Adjustment for cumulative effect of applying new accounting method (FIFO)		<u>20</u>
Retained earnings, January 1, as adjusted	\$2,240	1,180
Net Income	<u>900</u>	<u>1,060</u>
Retained earnings, December 31	<u>\$3,140</u>	<u>\$2,240</u>

EXERCISE 22-4 (25–30 minutes)

	<u>2004</u>
(a) Retained earnings, January 1, as reported	\$160,000
Cumulative effect of change in accounting principle to average cost.....	<u>(15,000)*</u>
Retained earnings, January 1, as adjusted	<u>\$145,000</u>

*[\$10,000 (2002) + \$5,000 (2003)]

	<u>2007</u>
(b) Retained earnings, January 1, as reported	\$590,000
Cumulative effect of change in accounting principle to average cost.....	<u>(25,000)*</u>
Retained earnings, January 1, as adjusted	<u>\$565,000</u>

*[\$10,000 (2002) + \$5,000 (2003) + \$10,000 (2004) – \$10,000 (2005) + \$10,000 (2006)]

	<u>2008</u>
(c) Retained earnings, January 1, as reported	\$780,000
Cumulative effect of change in accounting principle to average cost.....	<u>(20,000)*</u>
Retained earnings, January 1, as adjusted	<u>\$760,000</u>

*(\$25,000 at 12/31/2006 – \$5,000)

	<u>2005</u>	<u>2006</u>	<u>2007</u>
(d) Net Income	<u>\$130,000</u>	<u>\$290,000</u>	<u>\$310,000</u>

EXERCISE 22-5 (30–35 minutes)

(a)

**KENSETH COMPANY
Income Statement
For the Year Ended**

	<u>2007</u>	<u>2006</u>
Sales.....	\$3,000	\$3,000
Cost of goods sold.....	1,100	940
Operating expenses	<u>1,000</u>	<u>1,000</u>
Income before profit sharing	\$ 900	\$1,060
Profit sharing expense.....	<u>96</u>	<u>100</u>
Net income	<u>\$ 804</u>	<u>\$ 960</u>

Under *SFAS No. 154*, Kenseth Company should report \$100 as the profit sharing expense in 2006, even though the profit sharing expense would be \$106 if FIFO had been used in 2006.

(b) The profit sharing expense reflects an indirect effect of the change in accounting principle. Under *SFAS No. 154*, indirect effects from periods before the change are recorded in the year of the change. In this case, profit sharing expense recorded in 2007 is composed of:

$$\begin{aligned}
 & \$900 \times 10\% = \$90 \text{ (2007 under FIFO)} \\
 & \$ 60 \times 10\% = \underline{6} \text{ (difference in profit sharing for 2006)} \\
 & \qquad \qquad \underline{\$96} \text{ (profit sharing expense for FIFO in 2007)}
 \end{aligned}$$

(c)

Retained Earnings Statement

	<u>2007</u>
Retained earnings, January 1, as reported.....	\$8,000
Cumulative effect of change to FIFO (\$960 – \$900).....	<u>60</u>
Retained earnings, January 1, as adjusted.....	8,060
Add: Net Income	804
Deduct: Dividends.....	<u>2,000</u>
Retained earnings, December 31	<u>\$6,864</u>

EXERCISE 22-6 (30–35 minutes)

(a) Depreciation to date on equipment

Sum-of-the-years'-digits depreciation

2005 (5/15 X \$510,000)	\$170,000
2006 (4/15 X \$510,000)	136,000
2007 (3/15 X \$510,000)	<u>102,000</u>
	<u>\$408,000</u>

Cost of equipment	\$525,000
Depreciation to date	<u>408,000</u>
Book value (December 31, 2007)	<u>\$117,000</u>

Book value – Salvage value = Depreciable cost
 \$117,000 – \$15,000 = \$102,000

Depreciation for 2008: \$102,000/2 = \$51,000

Depreciation Expense	51,000	
Accumulated Depreciation—Equipment		51,000

(b) Depreciation to date on building

\$693,000/30 years = \$23,100 per year
 \$23,100 X 3 = \$69,300 depreciation to date

Cost of building	\$693,000
Depreciation to date	<u>69,300</u>
Book value (December 31, 2007)	<u>\$623,700</u>

Depreciation for 2008: \$623,700/(40 – 3) = \$16,856.76

Depreciation Expense	16,856.76	
Accumulated Depreciation—Buildings		16,856.76

EXERCISE 22-7 (25–30 minutes)

(a) Change from sum-of-the-years digit to straight-line

Cost of depreciable assets.....	\$100,000
Depreciation in 2007 ($\$100,000 \times 4/10$).....	<u>40,000</u>
Book value at December 31, 2007.....	<u>\$ 60,000</u>

Depreciation for 2008 using straight-line depreciation

Book value at December 31, 2007.....	\$60,000
Estimated useful life.....	3 years
Depreciation for 2008 ($\$60,000 \div 3$).....	\$20,000

**DENISE HABBE INC.
Retained Earnings Statement
For the Year Ended**

	<u>2008</u>	<u>2007</u>
Retained earnings, January 1, unadjusted.....	\$125,000	
Less: Correction of error for inventory overstatement.....	<u>(24,000)</u>	
Retained earnings, January 1, adjusted.....	101,000	\$ 72,000
Add: Net income	86,000	54,000
Less: Dividends.....	<u>30,000</u>	<u>25,000</u>
Retained earnings, December 31.....	<u>\$157,000</u>	<u>\$101,000</u>

Note to instructor:

1. 2007 Cost of sales increased \$24,000; 2008 cost of sales decreased \$24,000. As a result, net income for 2007 is overstated \$24,000 and net income for 2008 is understated \$24,000 as a result of the inventory error.
2. 2007 expenses remained unchanged.
3. 2008 expenses decreased \$10,000 ($\$30,000 - \$20,000$). Net income in 2008 is therefore \$86,000 ($\$52,000 + \$24,000 + \$10,000$).
4. Additional disclosures would be a necessitated as indicated in the chapter.

EXERCISE 22-7 (Continued)

5. Another acceptable presentation for the retained earnings statement for 2008 is:

Retained earnings, January 1, as reported	\$125,000
Prior period adjustment—inventory error	<u>24,000</u>
Retained earnings, January 1, as adjusted	101,000
Add: Net Income.....	86,000
Less: Dividends.....	<u>30,000</u>
Retained earnings, December 31.....	<u>\$157,000</u>

EXERCISE 22-8 (5–10 minutes)

- | | |
|-------|--------|
| 1. a. | 6. a. |
| 2. b. | 7. b. |
| 3. a. | 8. a. |
| 4. b. | 9. b. |
| 5. b. | 10. b. |

EXERCISE 22-9 (15–20 minutes)

December 31, 2008		
Retained Earnings (\$550,000 X 9/55).....	90,000	
Accumulated Depreciation—Machinery.....		90,000
(To correct for the omission of depreciation expense in 2006)		

Cost of Machine	\$550,000
Less: Depreciation prior to 2008	
2005 (\$550,000 X 10/55)	\$100,000
2006 (\$550,000 X 9/55)	90,000
2007 (\$550,000 X 8/55)	<u>80,000</u>
Book Value at January 1, 2008	<u>\$280,000</u>

Depreciation for 2008: $\$280,000 \div 7 = \$40,000$

Depreciation Expense	40,000	
Accumulated Depreciation—Machinery.....		40,000
(To record depreciation expense for 2008)		

EXERCISE 22-10 (20–25 minutes)

(a) Computation of depreciation for 2008:

Cost of building			\$800,000	
Less: Depreciation prior to 2008				
2004 (\$800,000 – \$0)	X .05*	\$40,000		
2005 (\$800,000 – \$40,000)	X .05	38,000		
2006 (\$800,000 – \$78,000)	X .05	36,100		
2007 (\$800,000 – \$114,100)	X .05	<u>34,295</u>	<u>148,395</u>	
Book value, January 1, 2008				<u>\$651,605</u>

*(1 ÷ 40) X 2

Depreciation expense for 2008: \$16,711 [(\$651,605 – \$50,000) ÷ 36]

Depreciation Expense	16,711	
Accumulated Depreciation—Building		16,711

(b) Computation of 2008 depreciation expense on the equipment:

Cost of equipment	\$100,000
Accumulated depreciation	
[(\$100,000 – \$10,000) ÷ 12] X 4 years	<u>30,000</u>
Book value, 1/1/08	<u>\$ 70,000</u>

2008 Depreciation expense: $\frac{\$70,000 - \$5,000}{(9 - 4)} = \frac{\$65,000}{5} = \underline{\underline{\$13,000}}$

EXERCISE 22-11 (10–15 minutes)

(a) No entry necessary. Changes in estimates are treated prospectively.

(b) Depreciation Expense	19,375*	
Accumulated Depreciation—Equipment		19,375

*Original cost	\$510,000
Accumulated depreciation	
[(\$510,000 – \$10,000) ÷ 10] X 7	<u>(350,000)</u>
Book value (1/1/08)	160,000
Estimated salvage value	<u>(5,000)</u>
Remaining depreciable basis	155,000
Remaining useful life	
(15 years – 7 years)	<u>÷ 8</u>
Depreciation expense—2008	<u>\$ 19,375</u>

EXERCISE 22-12 (20–25 minutes)

(a) Cost of plant assets	\$1,600,000
Less: Depreciation prior to 2008	
2005 (\$1,600,000 X .25)	\$400,000
2006 (\$1,200,000 X .25)	300,000
2007 (\$ 900,000 X .25)	<u>225,000</u>
Book value at January 1, 2008	<u>925,000</u>
	<u>\$675,000</u>

2008 Depreciation: $(\$675,000 - \$100,000) \div 5 = \$115,000$

Depreciation Expense	115,000	
Accumulated Depreciation—Plant Assets		115,000

	2008	2007
(b) Income before depreciation expense	\$300,000	\$270,000
Depreciation expense	<u>115,000</u>	<u>225,000</u>
Net income	<u>\$185,000</u>	<u>\$ 45,000</u>

EXERCISE 22-13 (10–15 minutes)

(a) The net income to be reported in 2008, using the retrospective approach, would be computed as follows:

Income before income tax	\$900,000
Income tax (40% X \$900,000)	<u>360,000</u>
Net income	<u>\$540,000</u>

(b) Construction in Process	290,000	
Deferred Tax Liability (40% X \$290,000)		116,000
Retained Earnings		174,000*

* $(\$290,000 \times 60\% = \$174,000)$

EXERCISE 22-14 (20–35 minutes)

(a) Retained Earnings.....	8,000	
Inventory.....		8,000*

*2005	\$2,000	(\$26,000 – \$24,000)
2006	5,000	(\$30,000 – \$25,000)
2007	<u>1,000</u>	(\$28,000 – \$27,000)
	<u>\$8,000</u>	

	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>
Net income	<u>\$30,000</u>	<u>\$27,000</u>	<u>\$25,000</u>	<u>\$24,000</u>

(b) Inventory.....	19,000	
Retained Earnings.....		19,000*

*2005	\$ 6,000	(\$26,000 – \$20,000)
2006	9,000	(\$30,000 – \$21,000)
2007	<u>4,000</u>	(\$28,000 – \$24,000)
	<u>\$19,000</u>	

	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>
Net income	<u>\$34,000</u>	<u>\$28,000</u>	<u>\$30,000</u>	<u>\$26,000</u>

EXERCISE 22-15 (15–20 minutes)

1. Accumulated Depreciation—Machinery	25,500	
Depreciation Expense		8,500
Retained Earnings.....		17,000

	<u>2006–2007</u>	<u>2008</u>
Depreciation taken	\$170,000*	\$85,000
Depreciation (correct)	<u>153,000</u>	<u>76,500</u>
	<u>\$ 17,000</u>	<u>\$ 8,500</u>

*\$510,000 X 1/6 X 2

2. Retained Earnings.....	45,000	
Sales Salaries Expense		45,000

3. No entry necessary.

EXERCISE 22-15 (Continued)

4.	Amortization Expense—Copyright	2,250	
	Retained Earnings	4,500	
	Copyright		6,750
	(\$45,000 ÷ 20 = \$2,250; \$2,250 X 2 = \$4,500)		
5.	Loss on Write-down of Inventories.....	87,000	
	Retained Earnings		87,000

EXERCISE 22-16 (10–15 minutes)

1.	Wages Expense	3,400	
	Wages Payable.....		3,400
2.	Vacation Wages Expense.....	31,100	
	Vacation Wages Payable		31,100
3.	Prepaid Insurance (\$2,640 X 10/12).....	2,200	
	Insurance Expense		2,200
4.	Sales Revenue	120,000	
	[\$2,120,000 ÷ (1.00 + .06)] X 6%		
	Sales Tax Payable.....		120,000
	Sales Tax Payable.....	103,400	
	Sales Tax Expense		103,400

EXERCISE 22-17 (10–15 minutes)

Retained Earnings	37,700	
Inventory		16,200
Accumulated Depreciation—Equipment.....		21,500
(\$38,500 – \$17,000)		

Computations:

	<u>Effect on retained earnings over (under) statement</u>
Overstatement of 2008 ending inventory	\$16,200
Overstatement of 2007 depreciation	(17,000)
Understatement of 2008 depreciation	<u>38,500</u>
Total effect of errors on retained earnings	<u>\$37,700</u>

Note: The understatement of inventory in 2007 was a self-correcting error at the end of 2008.

EXERCISE 22-18 (25–30 minutes)

(a) Effect of errors on 2008 net income: \$24,700 overstatement

Computations:

	<u>Effect on 2008 net income over (under) statement</u>
Understatement of 2007 ending inventory	\$ 9,600
Overstatement of 2008 ending inventory	8,100
Expensing of insurance premium in 2007 (\$66,000 ÷ 3)	22,000
Failure to record sale of fully depreciated machine in 2008	<u>(15,000)</u>
Total effect of errors on net income (overstated)	<u>\$24,700</u>

(b) Effect of errors on working capital: \$28,900 understatement

Computations:

	<u>Effect on working capital over (under) statement</u>
Overstatement of 2008 ending inventory	\$ 8,100
Expensing of insurance premium in 2007 (prepaid insurance)	(22,000)
Sale of fully depreciated machine unrecorded	<u>(15,000)</u>
Total effect on working capital (understated)	<u>\$(28,900)</u>

(c) Effect of errors on retained earnings: \$26,600 understatement

Computations:

	<u>Effect on retained earnings over (under) statement</u>
Overstatement of 2008 ending inventory	\$ 8,100
Understatement of depreciation expense in 2007	2,300
Expensing of insurance premium in 2007	(22,000)
Failure to record sale of fully depreciated machine in 2008	<u>(15,000)</u>
Total effect on retained earnings (understated)	<u>\$(26,600)</u>

EXERCISE 22-19 (20–25 minutes)

(a)	1. Supplies Expense (\$2,700 – \$1,100)	1,600	
	Supplies on Hand.....		1,600
2.	Salary and Wages Expense	2,900	
	(\$4,400 – \$1,500) Accrued Salaries and Wages		2,900
3.	Interest Revenue (\$5,100 – \$4,350)	750	
	Interest Receivable on Investments		750
4.	Insurance Expense	25,000	
	(\$90,000 – \$65,000) Prepaid Insurance.....		25,000
5.	Rental Income (\$28,000 ÷ 2)	14,000	
	Unearned Rent		14,000
6.	Depreciation Expense	45,000	
	(\$50,000 – \$5,000) Accumulated Depreciation		45,000
7.	Retained Earnings	7,200	
	Accumulated Depreciation		7,200
(b)	1. Retained Earnings	1,600	
	Supplies on Hand.....		1,600
2.	Retained Earnings	2,900	
	Accrued Salaries and Wages		2,900
3.	Retained Earnings	750	
	Interest Receivable on Investments		750
4.	Retained Earnings	25,000	
	Prepaid Insurance.....		25,000
5.	Retained Earnings	14,000	
	Unearned Rent		14,000
6.	Retained Earnings	45,000	
	Accumulated Depreciation		45,000
7.	Same as in (a).		

EXERCISE 22-20 (20–25 minutes)

	<u>2007</u>	<u>2008</u>
Income before tax	\$101,000	\$77,400
Corrections:		
Sales erroneously included in 2007 income	(38,200)	38,200
Understatement of 2007 ending inventory	8,640	(8,640)
Adjustment to bond interest expense*	(1,450)	(1,552)
Repairs erroneously charged to the Equipment account	(8,500)	(9,400)
Depreciation recorded on improperly capitalized repairs (10%)***	<u>850</u>	<u>1,790</u>
Corrected income before tax	<u>\$ 62,340</u>	<u>\$97,798</u>

*Bond interest expense for 2007 and 2008 was computed as follows:

	<u>Book Value of Bonds</u>	<u>Stated Interest</u>	<u>Effective Interest</u>
2007	\$235,000	\$15,000	\$16,450**
2008	236,450	15,000	16,552

**\$235,000 X 7%

Difference between effective interest at 7% and stated interest (6%):

2007:	\$1,450
2008:	1,552

***Erroneous depreciation taken in 2008:

on 2007 addition ($\$8,500 \div 10$)	\$ 850
on 2008 addition ($\$9,400 \div 10$)	<u>940</u>
Total excess depreciation 2008	<u>\$1,790</u>

EXERCISE 22-21 (10–15 minutes)

Item	2007			2008		
	Over- statement	Under- statement	No Effect	Over- statement	Under- statement	No Effect
(1)			X	X		
(2)		X		X		
(3)			X			X
(4)	X				X	
(5)		X		X		

***EXERCISE 22-22 (25–30 minutes)**

Because Streisand Co. now has a 30% interest in John Corp. as of 7/1/08, it is necessary to first adjust the investment in John to the equity method in prior periods. The following schedule provides this information:

	<u>12/31/07</u>	<u>6/30/08</u>
Streisand's equity in earnings of John Corp. (10%)	\$70,000	\$50,000
Dividends received	<u>0</u>	<u>0</u>
Adjustment	<u>\$70,000</u>	<u>\$50,000</u>

Note to instructor: Under SFAS No. 142, goodwill is not amortized.

A computation of the ending balance in the investment account of John Corp. can now be made as follows:

Investment in John Corp. 1/1/07	\$1,400,000
Additional purchase 7/1/08	3,040,000
Adjustment for 2007 income (prior period)	70,000
Adjustment for 2008 income to 6/30 (prior period)	50,000
Income (7/1/08–12/31/08) \$815,000 X 30%	244,500
Dividends (7/1/08–12/31/08) \$1.55 X 75,000 shares	<u>(116,250)</u>
Investment in John Corp. 12/31/08	<u>\$4,688,250</u>

***EXERCISE 22-23 (15–20 minutes)**

- (a) Prior to January 2, 2007, Aykroyd Corp. carried the investment in Belushi Company under the equity method of accounting as evidenced from the entries in the investment account. Use of the equity method was appropriate because Aykroyd's interest in Belushi exceeded 20%. With the sale of 126,000 shares, Aykroyd's interest dropped to 12% and it could no longer use the equity method of accounting for the investment. Aykroyd must change to the fair value method. Cessation of the equity method (increasing the investment for the proportionate share of earnings and decreasing it for dividends received) occurs immediately. The carrying value of the remaining 12% interest becomes the carrying amount for the fair value method with adjustments for cumulative excess dividends received after the change from the equity method over its share of Belushi Company's earnings. That carrying amount is transferred from the investment in Belushi account to the Available-for-Sale Securities account.
- (b) The carrying amount of the investment in Belushi as of December 31, 2007, would be computed as follows:

Carrying amount, 12/31/06 (from the given account information)	\$3,690,000
Less portion attributable to 126,000 shares sold 1/2/07	<u>(2,214,000)^a</u>
Balance, 1/2/07	1,476,000
Less cumulative excess dividends received over share of Belushi earnings	<u>(14,400)^b</u>
Carrying amount, 12/31/07	<u>\$1,461,600</u>

^a\$3,690,000 X 126/210

^bComputation of Excess Dividends Received over Share of Earnings:

	Dividends Received	Share of Belushi Co. Income	Excess Dividends Received Over Share of Earnings
2007	\$50,400	\$36,000 ^c	\$(14,400)

^c\$300,000 X 12% = \$36,000

***EXERCISE 22-23 (Continued)**

Note to instructor: The entry in 2007 to record the receipt of the dividend would be:

Cash	50,400	
Available-for-Sale Securities.....		14,400
Dividend Revenue.....		36,000

(c) The entry to recognize the excess of fair value over the carrying amount of the securities is as follows:

December 31, 2007		
Securities Fair Value Adjustment		
(Available-for-Sale)	108,400	
Unrealized Holding Gain or Loss—		
Equity (\$1,570,000 – \$1,461,600)		108,400

TIME AND PURPOSE OF PROBLEMS

Problem 22-1 (Time 30–35 minutes)

Purpose—to provide a problem that requires the student to: (1) account for a change in estimate, (2) record a correction of an error, and (3) account for a change in accounting principle. The student is also required to compute corrected/adjusted net income amounts.

Problem 22-2 (Time 30–40 minutes)

Purpose—to develop an understanding of the way in which accounting changes and error corrections are handled in accounting records. The problem presents descriptions of various situations for which the student is required to indicate the correct accounting treatment and to prepare comparative income statements for a four-year period.

Problem 22-3 (Time 25–30 minutes)

Purpose—to provide a problem that requires the student to: (1) prepare correcting entries for two years' unrecorded sales commissions, (2) three years' inventory errors, and (3) prepare entries for two different accounting changes.

Problem 22-4 (Time 25–30 minutes)

Purpose—to allow the student to see the impact of accounting changes on income and to examine an ethical situation related to the motivation for change.

Problem 22-5 (Time 40–50 minutes)

Purpose—to develop an understanding of the impact which a change in the method of inventory pricing (from LIFO to average cost) has on the financial statements during a five-year period. The student is required to prepare a comparative statement of income and retained earnings for the five years assuming the change in inventory pricing with an indication of the effects on net income and earnings per share for the years involved.

Problem 22-6 (Time 30–40 minutes)

Purpose—to develop an understanding of the journal entries and the reporting which are necessitated by an accounting change or correction of an error. The student is required to prepare the entries to reflect such changes or errors and the comparative income statements and retained earnings statements for a two-year period.

Problem 22-7 (Time 30–35 minutes)

Purpose—to provide a problem that requires the student to analyze eleven transactions and to prepare adjusting or correcting entries for these transactions.

Problem 22-8 (Time 20–25 minutes)

Purpose—to help a student understand the effect of errors on income and retained earnings. The student must analyze the effects of six errors on the current year's net income and on the next year's ending retained earnings balance.

Problem 22-9 (Time 20–25 minutes)

Purpose—to develop an understanding of the effect that errors have on the financial statements. The student is required to prepare a schedule portraying the corrected net income for the years involved with this error analysis.

Time and Purpose of Problems (Continued)

Problem 22-10 (Time 50–60 minutes)

Purpose—to develop an understanding of the correcting entries and income statement adjustments that are required for changes in accounting policies and accounting errors. This comprehensive problem involves many different concepts such as consignment sales, bonus computations, warranty costs, and bank funding reserves. The student is required to prepare the necessary journal entries to correct the accounting records and a schedule showing the revised income before taxes for each of the three years involved.

***Problem 22-11** (Time 20–25 minutes)

Purpose—to provide the student with a problem involving an investment that grows from 10% to 40% (from lack of significant influence to significant influence). The student is required to account for the effect of this change on income and to include the amortization of goodwill arising from acquisition of the investment.

***Problem 22-12** (Time 20–25 minutes)

Purpose—to provide the student with an understanding of the proper entries to reflect a change from the cost method to the equity method in accounting for an investment. The student is required to prepare the necessary journal entries for a three-year period with respect to this stock investment and the change in reporting methods.

SOLUTIONS TO PROBLEMS

PROBLEM 22-1

(a)	1.	Cost of equipment	\$65,000
		Less: Salvage value	<u>5,000</u>
		Depreciable cost	<u>\$60,000</u>

Depreciation to 2007		
2004 (\$60,000/10)	\$	6,000
2005 (\$60,000/10)		6,000
2006 (\$60,000/10)		<u>6,000</u>
		<u>\$18,000</u>

Depreciation in 2007		
Cost of equipment		\$65,000
Less: Depreciation to 2007		<u>18,000</u>
Book value (January 1, 2007)		47,000
Less: Salvage value		<u>3,000</u>
Depreciable cost		<u>\$44,000</u>

Depreciation in 2007
 $\$44,000/4 = \$11,000$

Depreciation Expense	11,000	
Accumulated Depreciation—Equipment ..		11,000

2.	Cost of Building	\$300,000	
	Less: Depreciation to 2007		
	2005	60,000	
	2006	<u>48,000</u>	
	Book value (January 1, 2007)	\$192,000	
	Less: Salvage value	<u>30,000</u>	
	Depreciable cost	<u>\$162,000</u>	

Depreciation in 2007
 $(\$162,000/8) = \$20,250$

Depreciation Expense	20,250	
Accumulated Depreciation—Building		20,250

PROBLEM 22-1 (Continued)

3. Accumulated Depreciation—Machine.....	1,500	
Retained Earnings		1,500
([2005: \$10,000* – \$9,000** X 1/2 year]		
+ [2006: \$10,000* – \$9,000**])		

***\$80,000 ÷ 8 **(\$80,000 – \$8,000) ÷ 8**

**(b) BRUEGGEN COMPANY
Comparative Income Statements
For the Years 2007 and 2006**

	<u>2007</u>	<u>2006</u>
Income before depreciation expense	\$300,000	\$310,000
Depreciation expense*	<u>40,250</u>	<u>63,000</u>
Net income	<u>\$259,750</u>	<u>\$247,000</u>
 *Depreciation Expense	 <u>2007</u>	 <u>2006</u>
Equipment.....	\$11,000	\$ 6,000
Building.....	20,250	48,000
Machine.....	<u>9,000</u>	<u>9,000</u>
	<u>\$40,250</u>	<u>\$63,000</u>

PROBLEM 22-2

- (a) 1. Bad debt expense for 2005 should not have been reduced by \$12,000. A change in the experience rate is considered a change in estimate, which should be handled prospectively.
2. A change from LIFO to FIFO is considered a change in accounting principle, which must be handled retrospectively.
3. a. The inventory error in 2007 is a prior period adjustment and the 2007 and 2008 statements should be restated.
- b. The lawsuit settlement is correctly treated.

(b) **LARRY KINGSTON INC.**
Comparative Income Statements
For the Years 2005 through 2008

	2005	2006	2007	2008
Income before extraordinary item	\$143,000	\$125,000*	\$204,000	\$271,000
Extraordinary gain		40,000		
Net income (see below)	<u>\$143,000</u>	<u>\$165,000</u>	<u>\$204,000</u>	<u>\$271,000</u>
	2005	2006	2007	2008
Net income (unadjusted)	\$140,000	\$160,000	\$205,000	\$276,000
1. Bad debt expense adjustment	(12,000)			
2. Inventory adjustment (FIFO)	15,000	5,000	10,000	(16,000)
3. Inventory overstatement			(11,000)	11,000
4. Tax settlement				
Net income (adjusted)	<u>\$143,000</u>	<u>\$165,000*</u>	<u>\$204,000</u>	<u>\$271,000</u>

*The income before extraordinary item in 2006 is \$125,000 (\$165,000 – \$40,000).

PROBLEM 22-3

1.	Retained Earnings	4,000	
	Sales Commissions Payable.....		2,500
	Sales Commissions Expense		1,500
2.	Cost of Goods Sold (\$21,000 + \$6,700).....	27,700	
	Retained Earnings		21,000
	Inventory		6,700

Income Overstated (Understated)

	2006	2007	2008
Beginning inventory		\$ 16,000	\$21,000
Ending inventory	<u>\$(16,000)</u>	<u>(21,000)</u>	<u>6,700</u>
	<u>\$(16,000)</u>	<u>\$ (5,000)</u>	<u>\$27,700</u>

3.	Accumulated Depreciation—Equipment.....	4,800	
	Depreciation Expense		4,800*

*Equipment cost	\$100,000
Depreciation before 2008	<u>(36,000)</u>
Book value	<u>\$ 64,000</u>

Depreciation to be taken (\$64,000/8)	\$ 8,000
Depreciation recorded	<u>12,800</u>
Difference	<u>\$ 4,800</u>

4.	Construction in Process.....	55,000	
	Deferred Tax Liability.....		22,000*
	Retained Earnings		33,000

*(\$150,000 – \$95,000) X 40%

PROBLEM 22-4

(a)

PLATO CORPORATION
Projected Income Statement
For the Year Ended December 31, 2007

Sales		\$29,000,000
Cost of goods sold	\$14,000,000	
Depreciation expense	1,600,000^a	
Operating expenses	<u>6,400,000</u>	<u>22,000,000</u>
Income before income taxes		\$ 7,000,000
Unrealized holding gain		<u>2,000,000^b</u>
Income before taxes and bonus		\$ 9,000,000
President's bonus		<u>1,000,000</u>
Income before income taxes		\$ 8,000,000
Income taxes		
Current	\$ 3,000,000	
Deferred	<u>1,000,000^c</u>	<u>4,000,000</u>
Net income		<u>\$ 4,000,000</u>

Conditions met:

1. Net income before taxes and bonus > \$8,000,000.
2. Payable for income taxes does not exceed \$3,000,000.

^aDepreciation for the current year includes \$600,000 for the old equipment and \$2,000,000 for the robotic equipment. If the robotic equipment is changed to straight-line, its depreciation is only \$1,000,000 and the total is \$1,600,000.

^bBy urging the Board of Directors to change the classification of Securities A and D to Trading securities, income is increased by a \$2,000,000 recognition of a holding gain.

^cThe unrealized holding gain is not currently taxable until the securities are sold.

(b) Students' answers will vary.

There is nothing unethical about changing the first-year election of depreciation back to the straight-line method provided that it meets with the approval of appropriate corporate decision makers. Considering the immediate needs for cash of \$1,000,000 for the president's bonus

PROBLEM 22-4 (Continued)

and \$3,000,000 for income taxes, there may be a need to sell some of the marketable securities. Therefore, the transfer of \$3,000,000 of available-for-sale securities to trading securities may also be appropriate.

It is naive to believe that corporate officers do no planning for year-end (or interim) financial statements. The slippery slope arises with manipulation of financial statements. The security reclassification for the selected securities clearly manipulates the income to the benefit of the president. While legal and within GAAP guidelines, the ethics of this situation are borderline. Any auditor would automatically bring this transaction to the attention of the board of directors.

Some stakeholders and their interests are:

Stakeholder	Interests
President	Personal gain of \$1,000,000 bonus.
CFO	Placed in ethical dilemma between the interests of the president and the corporation.
Board of Directors	May be subject to the manipulations of the CEO for his personal gain.
Stockholders	Increased income from higher (paper) income may increase demand for dividends. Lower income from bonus may decrease cash available for dividends.
Employees	President takes 25% of net income for himself. This could have been used to start a pension plan for all of the employees.
Creditors	The increased income represents a 33% inflation of the true net income of the corporation. This may lead to unreliable decisions of creditworthiness.

PROBLEM 22-5

SCOTT KREITER INSTRUMENT COMPANY
Statement of Income and Retained Earnings
For the Years Ended May 31

	2003	2004	2005	2006	2007
Sales—net	<u>\$13,964</u>	<u>\$15,506</u>	<u>\$16,673</u>	<u>\$18,221</u>	<u>\$18,898</u>
Cost of goods sold					
Beginning inventory	950	1,124	1,091	1,270	1,480
Purchases	13,000	13,900	15,000	15,900	17,100
Ending inventory	<u>(1,124)</u>	<u>(1,091)</u>	<u>(1,270)</u>	<u>(1,480)</u>	<u>(1,699)</u>
Total	<u>12,826</u>	<u>13,933</u>	<u>14,821</u>	<u>15,690</u>	<u>16,881</u>
Gross profit	1,138	1,573	1,852	2,531	2,017
Administrative expenses	<u>700</u>	<u>763</u>	<u>832</u>	<u>907</u>	<u>989</u>
Income before taxes	438	810	1,020	1,624	1,028
Income taxes (50%)	<u>219</u>	<u>405</u>	<u>510</u>	<u>812</u>	<u>514</u>
Net income	<u>219</u>	<u>405</u>	<u>510</u>	<u>812</u>	<u>514</u>
Retained earnings—beginning:					
As originally reported	1,206	1,388	1,759	2,237	3,005
Adjustment (See note* and schedule)	<u>(25)</u>	<u>12</u>	<u>46</u>	<u>78</u>	<u>122</u>
As restated	<u>1,181</u>	<u>1,400</u>	<u>1,805</u>	<u>2,315</u>	<u>3,127</u>
Retained earnings—ending	<u>\$ 1,400</u>	<u>\$ 1,805</u>	<u>\$ 2,315</u>	<u>\$ 3,127</u>	<u>\$ 3,641</u>
Earnings per share (100 shares)	<u>\$ 2.19</u>	<u>\$ 4.05</u>	<u>\$ 5.10</u>	<u>\$ 8.12</u>	<u>\$ 5.14</u>

***Note to instructor:**

The retained earnings balances are usually reported in the above manner. If desired, only the restated balances might be reported. The adjustments are simply the cumulative difference in income between the two inventory methods, net of tax. For example, the negative \$25 in 2003 reflects the difference in ending inventories in 2002 (\$1,000 – \$950) times the tax rate 50%. In 2004, the difference in income of \$37 between the two methods in 2003 is added to the negative \$25 to arrive at a \$12 adjustment to the beginning balance of retained earnings in 2004.

PROBLEM 22-5 (Continued)

In 2007, the Company changed its method of pricing inventory from the last-in, first out (LIFO) to the average cost method in order to more fairly present the financial operations of the company. The financial statements for prior years have been restated to retrospectively reflect this change, resulting in the following effects on net income and related per share amounts:

	Increase in				
	2003	2004	2005	2006	2007
Net income	\$ 37	\$ 34	\$ 32	\$ 44	\$ 44
Earnings per share	\$0.37	\$0.34	\$0.32	\$0.44	\$0.44

Schedule of Income Reconciliation and Retained Earnings Adjustments 2003–2007

	2002	2003	2004	2005	2006	2007
Beginning Inventory LIFO		\$1,000	\$1,100.00	\$1,000.00	\$1,115.00	\$1,237.00
Average Cost		<u>950</u>	<u>1,124.00</u>	<u>1,091.00</u>	<u>1,270.00</u>	<u>1,480.00</u>
Difference		50	(24.00)	(91.00)	(155.00)	(243.00)
Tax Effect (50%)		<u>25</u>	<u>12.00</u>	<u>45.50[†]</u>	<u>77.50[†]</u>	<u>121.50[†]</u>
Effect on Income*		<u>\$ 25</u>	<u>\$ (12.00)</u>	<u>\$ (45.50)[†]</u>	<u>\$ (77.50)[†]</u>	<u>\$ (121.50)</u>
Ending Inventory LIFO	\$1,000	\$1,100	\$1,000.00	\$1,115.00	\$1,237.00	\$1,369.00
Average Cost	<u>950</u>	<u>1,124</u>	<u>1,091.00</u>	<u>1,270.00</u>	<u>1,480.00</u>	<u>1,699.00</u>
Difference	50	(24)	(91.00)	(155.00)	(243.00)	(330.00)
Tax Effect (50%)	<u>25</u>	<u>12</u>	<u>45.50[†]</u>	<u>77.50[†]</u>	<u>121.50[†]</u>	<u>165.00</u>
Effect on Income**	<u>\$ (25)</u>	<u>\$ 12</u>	<u>\$ 45.50[†]</u>	<u>\$ 77.50[†]</u>	<u>\$ 121.50[†]</u>	<u>\$ 165.00</u>
Net Effect on Income	<u>\$ (25)</u>	<u>\$ 37</u>	<u>\$ 33.50[†]</u>	<u>\$ 32.00</u>	<u>\$ 44.00</u>	<u>\$ 43.50[†]</u>
Cumulative Effect on Beginning Retained Earnings		<u>\$ 12</u>	<u>\$ 45.50[†]</u>	<u>\$ 77.50[†]</u>	<u>\$ 121.50</u>	<u>\$ 165.00</u>

*Larger (smaller) beginning inventory has negative (positive) effect on net income.

**Larger (smaller) ending inventory has positive (negative) effect on net income.

[†]The tax effects are rounded up to the next whole dollar in the problem. Therefore, the net effects on income and retained earnings are effectively rounded down to the next whole dollar.

PROBLEM 22-6

(a)	1.	Depreciation Expense..... Accumulated Depreciation—Asset A	86,625 86,625	 86,625
		Computations: Cost of Asset A Less: Depreciation prior to 2008 Book value, January 1, 2008	\$495,000 <u>148,500*</u> <u>\$346,500</u>	
		*(\$495,000 ÷ 10) X 3 Depreciation for 2008: \$346,500 X 7/28** = \$86,625 **[7(7 + 1)] ÷ 2 = 28		
	2.	Depreciation Expense..... Accumulated Depreciation—Asset B	17,000 17,000	 17,000
		Computations: Original cost Accumulated depreciation (1/1/08) \$8,000 X 4 Book value (1/1/08) Estimated salvage value Remaining depreciable base Remaining useful life (9 years—4 years taken) Depreciation expense—2008	\$120,000 <u>32,000</u> 88,000 <u>3,000</u> 85,000 ÷ <u>5</u> <u>\$ 17,000</u>	
	3.	Asset C..... Accumulated Depreciation—Asset C (4 X \$14,000) Retained Earnings.....	140,000 56,000 84,000	 56,000 84,000
		Depreciation Expense..... Accumulated Depreciation—Asset C	14,000 14,000	 14,000

PROBLEM 22-6 (Continued)

**(b) KELTSNER INC.
Comparative Retained Earnings Statements
For the Years Ended**

	<u>2008</u>	<u>2007</u>
Retained earnings, January 1, as previously reported		\$200,000
Add: Error in recording Asset C		<u>98,000*</u>
Retained earnings, January 1, as adjusted	\$654,000	298,000
Add: Net income	<u>227,375**</u>	<u>356,000</u>
Retained earnings, December 31	<u>\$881,375</u>	<u>\$654,000</u>
*Amount expensed incorrectly in 2004		\$140,000
Depreciation to be taken to January 1, 2007 (\$14,000 X 3)		<u>42,000</u>
Prior period adjustment for income		<u>\$ 98,000</u>
**Income before depreciation expense (2008)		\$400,000
Depreciation for 2008		
Asset A	\$86,625	
Asset B	17,000	
Asset C	14,000	
Other	<u>55,000</u>	<u>(172,625)</u>
Income after depreciation expense		<u>\$227,375</u>

PROBLEM 22-7

	(1)		
Depreciation Expense.....		3,200	
Accumulated Depreciation—Delivery Vehicles.....			3,200
	(2)		
Income Summary.....		19,000	
Retained Earnings.....			19,000
	(3)		
No entry.			
	(4)		
Cash.....		5,600	
Accounts Receivable.....			5,600
	(5)		
Accumulated Depreciation—Equipment		22,000	
Equipment.....			18,300
Gain on Sale of Equipment			3,700
	(6)		
Estimated Litigation Loss.....		125,000	
Estimated Litigation Liability.....			125,000
	(7)		
Unrealized Holding Gain or Loss—Income.....		2,000	
Securities Fair Value Adjustment (Trading)			2,000
	(8)		
Accrued Salaries Payable (\$16,000 – \$12,200)		3,800	
Salaries Expense			3,800
	(9)		
Depreciation Expense.....		4,000	
Equipment.....		32,000	
Repairs Expense.....			32,000
Accumulated Depreciation—Equipment			4,000

PROBLEM 22-7 (Continued)

	(10)		
Insurance Expense (\$15,000 ÷ 3)		5,000	
Prepaid Insurance		7,500	
Retained Earnings			12,500
	(11)		
Amortization Expense (\$50,000 ÷ 10)		5,000	
Retained Earnings		5,000	
Trademark			10,000

PROBLEM 22-8

Item	Net Income for 2006		Retained Earnings 12/31/07	
	Understated	Overstated	Understated	Overstated
1.	\$14,100	0	0	0
2.	\$ 7,000	0	\$ 5,000	0
3.	0	\$22,000	0	\$11,000
4.	\$33,000	0	\$33,000	0
5.	0	\$20,000	0	\$10,000
6.	\$18,200	0	0	0

Although explanations were not required in answering the question, they are included below for your interest.

Explanations:

1. The net income would be understated in 2006 because interest income is understated. The net income would be overstated in 2007 because interest income is overstated. The errors, however, would counter-balance (wash) so that the Balance Sheet (Retained Earnings) would be correct at the end of 2007.
2. The depreciation expense in 2006 should be \$1,000 for this machine. Since the machine was bought on July 1, 2006, only one-half of a year should be taken in 2006 ($\$8,000/4 \times 1/2 = \$1,000$). The company expensed \$8,000 instead of \$1,000 so net income is understated by \$7,000 in 2007. An additional \$2,000 of depreciation expense should have been taken in 2007. At the end of 2007, retained earnings would be understated by \$5,000 ($\$7,000 - \$2,000$).
3. In FASB No. 2 the FASB states that all research and development costs should be expensed when incurred. Net income in 2006 is overstated \$22,000 ($\$33,000$ research and development costs capitalized less $\$11,000$ amortized). By the end of 2007, only \$11,000 of the research and development costs would remain as an asset. Therefore, retained earnings would be overstated by \$11,000 ($\$33,000$ research and development costs – $\$22,000$ amortized).

PROBLEM 22-8 (Continued)

- 4. The security deposit should be a long-term asset, called refundable deposits. The \$8,000 of last month's rent is also an asset, called prepaid rent. The net income of 2006 is understated by \$33,000 ($\$25,000 + \$8,000$) because these amounts were expensed. Retained earnings will continue to be understated by \$33,000 until the last year of the lease. The security deposit will then be refunded, and the last month's rent should be expensed.**
- 5. \$10,000 or one-third of \$30,000 should be reported as income each year. In 2006, \$30,000 was reported as income when only \$10,000 should have been reported. Because \$20,000 too much was reported, the net income of 2006 is overstated. At the end of 2007, \$20,000 should have been reported as income, so retained earnings is still overstated by \$10,000 ($\$30,000 - \$20,000$).**
- 6. The ending inventory would be understated since the merchandise was omitted. Because ending inventory and net income have a direct relationship, net income in 2006 would be understated. The ending inventory of 2006 becomes the beginning inventory of 2007. If beginning inventory of 2007 is understated, then net income of 2007 is overstated (inverse relationship). The omission in inventory over the two-year period will counterbalance, and retained earnings at the end of 2007 will be correct.**

PROBLEM 22-9

	<u>2007</u>	<u>2008</u>
Net income, as reported	\$29,000	\$37,000
Rent received in 2007, earned in 2008	(1,300)	1,300
Wages not accrued, 12/31/06	1,100	
Wages not accrued, 12/31/07	(1,500)	1,500
Wages not accrued, 12/31/08		(940)
Inventory of supplies, 12/31/06	(1,300)	
Inventory of supplies, 12/31/07	740	(740)
Inventory of supplies, 12/31/08		1,420
Corrected net income	<u>\$26,740</u>	<u>\$39,540</u>

LARRY LANDERS COMPANY
Schedule of Revised Net Income
For the Years Ended March 31, 2006, 2007, and 2008

	COMPUTATIONS			SUMMARY		
	2006	2007	2008	2006	2007	2008
1. Net income as reported				\$71,600	\$111,400	\$103,580
2. Elimination of profit on consignments:						
Billed	\$ 6,500		\$ 5,590			
at 130% of cost	÷ 130%		÷ 130%			
Cost	<u>5,000</u>		<u>4,300</u>			
Profit error	\$ 1,500	\$ 1,500	\$ 1,290	(1,500)	1,500	(1,290)
3. To correct C.O.D. sale					6,100	(6,100)
4. Adjustment of warranty expense:						
Sales per books	\$940,000	\$1,010,000	\$1,795,000			
Correction for consignments	(6,500)	6,500	(5,590)			
Correction for C.O.D. sale		<u>6,100</u>	<u>(6,100)</u>			
Corrected sales	<u>\$933,500</u>	<u>\$1,022,600</u>	<u>\$1,783,310</u>			
Normal warranty expense, one-half of 1%	\$ 4,668	\$ 5,113	\$ 8,917			
Less costs charged to expense	760	1,670	3,850			
Additional expense	<u>3,908</u>	<u>3,443</u>	<u>5,067</u>	(3,908)	(3,443)	(5,067)
5. Bad debt adjustments:						
Normal bad debt expense, one-quarter of 1% of sales	\$ 2,334	\$ 2,557	\$ 4,458			
Less previous write-offs	750	1,320	3,850			
Additional expense	<u>1,584</u>	<u>1,237</u>	<u>608</u>	(1,584)	(1,237)	(608)
6. Adjustment for contract financing				3,000	3,900	5,100
7. Adjustment for commissions				<u>(1,400)</u>	600*	<u>(320)**</u>
8. Adjustment for bonus, one-half of 1% of income before taxes and bonus				66,208	118,820	95,295
Income before income taxes				<u>(331)</u>	<u>(594)</u>	<u>(476)</u>
				<u>\$65,877</u>	<u>\$118,226</u>	<u>\$ 94,819</u>

*\$1,400 – \$800

**\$800 – \$1,120

PROBLEM 22-10

PROBLEM 22-10 (Continued)

(b)

**LARRY LANDERS COMPANY
Journal Entries
March 31, 2008**

Sales	5,590	
Merchandise on Consignment	4,300	
Cost of Goods Sold.....		4,300
Accounts Receivable.....		5,590
(To adjust for consignments treated as sales, 3/31/08)		
Sales	6,100	
Retained Earnings.....		6,100
(To adjust for C.O.D. sales not recorded, 3/31/07)		
Warranty Expense	5,067	
Retained Earnings (\$3,908 + \$3,443).....	7,351	
Estimated Liability Under Warranties		12,418
(To set up allowance for warranty expense)		
Retained Earnings (\$331 + \$594).....	925	
Manager's Bonus Expense	476	
Accrued Bonus Payable.....		1,401
(To set up accrued bonus payable to manager)		
Retained Earnings (\$1,584 + \$1,237).....	2,821	
Bad Debt Expense.....	608	
Allowance for Doubtful Accounts.....		3,429
(To set up allowance for uncollectible accounts)		
Dealers' Fund Reserve (held by bank)	12,000	
Finance Expense		5,100
Retained Earnings (\$3,000 + \$3,900).....		6,900
(To record finance charge reserve held by bank)		

PROBLEM 22-10 (Continued)

Commissions Expense	320	
Retained Earnings (\$1,400 – \$600).....	800	
 Accrued Commissions Payable		1,120
 (To adjust for accrued commissions)		

*PROBLEM 22-11

(a) **LATOYA INC.**
Schedule of Income or Loss from Investment
For Year Ending December 31, 2006

Dividend revenue (10,000 shares X \$2.00 dividend/share)	<u>\$20,000</u>
---	-----------------

(b) **LATOYA INC.**
Schedule of Income or Loss from Investment
For Years Ending December 31, 2007 and 2006

	2007	2006
Income from investment in Jones (Schedule 1)	<u>\$185,000</u>	<u>\$50,000</u>

Schedule 1 **Latoya's Share of Investee's Income**

	2007	2006
Income for 2006 (\$500,000 X 10%)		\$50,000
Income for 2007		
First half (\$250,000 X 10%)	\$ 25,000	
Second half (\$400,000 X 40%)	<u>160,000</u>	
	<u>\$185,000</u>	<u>\$50,000</u>

*PROBLEM 22-12

January 3, 2005

Available-for-Sale Securities.....	500,000	
Cash		500,000
(To record the purchase of a 10% interest in Hobbes Corp.)		

December 31, 2005

Cash	15,000	
Dividend Revenue.....		15,000
(To record the receipt of cash dividends from Hobbes Corp.)		

December 31, 2005

Securities Fair Value Adjustment (Available-for-Sale)	70,000	
Unrealized Holding Gain or Loss—Equity		70,000
(To recognize as part of stockholders' equity the increase in fair value of available-for-sale securities)		

December 31, 2006

Cash	20,000	
Dividend Revenue.....		20,000
(To record the receipt of cash dividends from Hobbes Corp.)		

December 31, 2006

Unrealized Holding Gain or Loss—Equity	55,000	
Securities Fair Value Adjustment (Available-for-Sale)		55,000
(To recognize as part of stockholders' equity the decrease in fair value of available-for-sale securities)		

***PROBLEM 22-12 (Continued)**

January 2, 2007

Investment in Hobbes Corp.	1,560,000	
Cash		1,545,000
Retained Earnings		15,000
(To record purchase of additional interest in Hobbes and to reflect retroactively a change from the fair value to the equity method)		

Computation of Prior Period Adjustment

	<u>2005</u>	<u>2006</u>	<u>Total</u>
Calvin equity in earnings of Hobbes (10%)	\$35,000*	\$40,000	\$75,000
Amortization of excess of purchase price over underlying equity [\$500,000 – (\$3,750,000 X 10%) ÷ 10]	(12,500)	(12,500)	(25,000)
Dividend received	(15,000)	(20,000)	(35,000)
Prior period adjustment	<u>\$ 7,500</u>	<u>\$ 7,500</u>	<u>\$15,000</u>

***\$350,000 X 10%**

January 2, 2007

Investment in Hobbes Corp.	500,000	
Available-for-Sale Securities		500,000
(To reclassify investment carried under fair value method to investment carried under equity method)		
Unrealized Holding Gain or Loss—Equity Securities Fair Value Adjustment (Available-for-Sale)	15,000	
(To eliminate accounts and balances used under fair value method accounting)		

***PROBLEM 22-12 (Continued)**

December 31, 2007

Investment in Hobbes Corp.....	170,000	
Revenue from Investment.....		170,000
(To record equity in net income of Hobbes—40% of \$550,000 less \$50,000 amortization of excess cost over underlying equity)		
Computation of amortization:		
2005 purchase		
(\$125,000 ÷ 10 years)	\$12,500	
2007 purchase		
[\$1,545,000 – (\$4,150,000		
X 30%) ÷ 8 years]	<u>37,500</u>	
Total	<u>\$50,000</u>	
Cash	70,000	
Investment in Hobbes Corp.....		70,000
(To record the receipt of cash dividends from Hobbes Corp.)		

TIME AND PURPOSE OF CONCEPTS FOR ANALYSIS

CA 22-1 (Time 25–35 minutes)

Purpose—to provide the student with some familiarity with the applications of **SFAS No. 154**. This case describes several proposed accounting changes with which the student is required to identify whether the change involves an accounting principle, accounting estimate, or correction of an error, plus the necessary reporting requirements for each proposal.

CA 22-2 (Time 20–30 minutes)

Purpose—to provide the student with an understanding of the application and reporting requirements of **SFAS No. 154**. This case describes many different accounting changes with which the student is required to identify the type of change involved and to indicate which changes necessitate the restatement of prior years' financial statements when presented in comparative form with the current year's statement.

CA 22-3 (Time 30–35 minutes)

Purpose—to provide the student with an understanding of **SFAS No. 154** and its respective applications. This case describes three independent situations with which the student is required to identify the type of accounting change involved, the reporting which is necessitated under current generally accepted accounting principles, and the effects of each change on the financial statements.

CA 22-4 (Time 20–30 minutes)

Purpose—to provide the student with an understanding of how changes in accounting can be reflected in the accounting records to facilitate analysis and understanding of financial statements. This case involves several situations with which the student is required to indicate the appropriate accounting treatment that each should be given.

CA 22-5 (Time 30–40 minutes)

Purpose—to help a student identify the type of change and explain the accounting treatment required. The student discusses the impact on the external auditor's report for each of the four types of accounting changes. For each of seven changes described, the student explains which type of accounting change it is.

CA 22-6 (Time 20–30 minutes)

Purpose—to provide the student with an opportunity to explain how to account for various accounting change situations. Explanations for a change in estimate, change in principle, and change in entity are communicated in a written letter.

CA 22-7 (Time 20–30 minutes)

Purpose—to provide the student with an opportunity to explain the ethical issues related to changes in estimates.

SOLUTIONS TO CONCEPTS FOR ANALYSIS

CA 22-1

- (a)
1. **Uncollectible Accounts Receivable.** This is a change in accounting estimate. Restatement of prior periods is not appropriate.
 2. **Depreciation.**
 - a. This is a change in accounting estimate. Restatement of opening retained earnings is not appropriate.
 - b. This is a new method for a new class of assets. No change is involved.
 3. **Mathematical Error.** This is a correction of an error and prior period treatment would be in order.
 4. **Preproduction Costs—Furniture Division.** This should probably be construed as an inseparability situation in that the change in accounting estimate (period benefited by deferred costs) has been affected by a change in accounting principle (amortization on a per-unit basis). Consequently, it is treated as a change in accounting estimate. Restatement of opening retained earnings is not appropriate.
 5. **FIFO to LIFO Change.** This is a change in accounting principle. Restatement of December 31, 2007 retained earnings is not appropriate, given that the effect on net income in prior periods cannot be determined. Note that a LIFO to FIFO change does qualify for restatement of opening retained earnings, but FIFO to LIFO does not qualify in most cases because it is impracticable to determine prior year's income under LIFO.
 6. **Percentage of Completion.** This is a change in accounting principle. Retained earnings should be adjusted.
- (b) The adjustment to the December 31, 2007 retained earnings balance would be computed as follows:

Item 3	\$ (235,000)
Item 6	<u>1,175,000</u>
Increase in 12/31/07—Retained Earnings	<u>\$ 940,000</u>

CA 22-2

Item Change	Type of Change	Should Prior Years' Statements Be Retrospectively Applied or Restated?
1.	A change in accounting principle.	Yes
2.	A change in an accounting estimate.	No
3.	An accounting change involving both a change in accounting principle and a change in accounting estimate. Referred to as an change in accounting estimate effected by a change in principle. Handle as a change in estimate.	No
4.	Not an accounting change but rather a change in classification.	Yes
5.	An error correction not involving a change in accounting principle.	Yes
6.	An accounting change involving a change in the reporting entity which is a special type of change in accounting principle.	Yes
7.	Not a change in accounting principle. Simply, a change in tax accounting.	No
8.	An accounting change from one generally accepted accounting principle to another generally accepted accounting principle.	No*

*Generally impracticable to determine what LIFO inventory would be in prior periods.

CA 22-3

Situation 1.

- (a) A change from an accounting principle not generally accepted to one generally accepted is a correction of an error.
- (b) When comparative statements are presented, net income, components of net income, retained earnings, and any other affected balances for all periods presented should be restated to correct for the error. When single period statements are presented, the required adjustments should be reported in the opening balance of retained earnings. A description of the change and its effect on income before extraordinary items, net income, and the related per share amounts should be disclosed in the period of the change. Financial statements of subsequent periods need not repeat the disclosures.
- (c) The beginning balance of retained earnings in the balance sheet is restated. The income statement for the current year should report the correct approach for revenue recognition. If prior years' financial statements are presented, they should be restated directly.

CA 22-3 (Continued)

Situation 2.

- (a) The change in method of inventory pricing represents a change in accounting principle, as defined by **SFAS No. 154**.
- (b) Changes in accounting principle are accounted for through retrospective application. Under this approach, the cumulative effect of the new method on the financial statements at the beginning of the period is computed (and recorded in retained earnings at the beginning of the period). Prior statements are changed to be reported on a basis consistent with the new standard.
- (c) As a result of the change to weighted average costing, the current year balance sheet will reflect weighted average costing (at relatively higher prices in times of rising prices). Cost of goods sold will also be different (higher), resulting in lower income.

Situation 3.

- (a) A change in the depreciable lives of fixed assets is a change in accounting estimate.
- (b) In accordance with **SFAS No. 154**, the change in estimate should be reported in the current period and in future periods. Unlike a change in accounting principle, the change in accounting estimate should *not* be accounted for by presenting prior earnings data giving effect to the change as if it had been applied retrospectively.
- (c) This change in accounting estimate will affect the balance sheet in that the accumulated depreciation in the current and future years will increase at a different rate than previously reported, and this will also be reflected in depreciation expense in the income statement in the current and future years.

CA 22-4

- 1. This situation is a change in estimate. Whenever it is impossible to determine whether a change in principle or a change in estimate has occurred, the change should be considered a change in estimate. This is often referred to as a change in accounting estimate effected by a change in accounting principle. A change in estimate employs the current and prospective approach by:
 - a. Reporting current and future financial statements on the new basis.
 - b. Presenting prior periods' financial statements as previously reported.
 - c. Making no adjustments to current opening balances for purposes of catch-up.
- 2. This situation is considered a change in estimate because new events have occurred which call for a change in estimate. The accounting should be the same as discussed in 1.
- 3. This situation is considered a correction of an error. The general rule is that careful estimates which later prove to be incorrect should be considered changes in estimates. Where the estimate was obviously computed incorrectly because of lack of expertise or in bad faith, the adjustment should be considered an error. Changes due to error should employ the retroactive approach by:
 - a. Restating, via a prior period adjustment, the beginning balance of retained earnings for the current period.

CA 22-4 (Continued)

- b. Correcting all prior period statements presented in comparative financial statements. The amount of the error related to periods prior to the earliest year's statement presented for comparative purposes should be included as an adjustment to the beginning balance of retained earnings of that earliest year's statement.
4. No adjustment is necessary—a change in accounting principle is not considered to have happened if a new principle is adopted in recognition of events that have occurred for the first time.
5. This situation is considered a change in estimate because new events have occurred which call for a change in estimate. The accounting should be the same as discussed in 1.
6. This situation is considered a change in accounting principle. A change in accounting principle should employ the retrospective approach by:
 - a. Reporting current results on the new basis.
 - b. Presenting prior period financial statements on a basis consistent with the newly adopted method.
 - c. Computing the cumulative effect of the new method in beginning retained earnings on the earliest year presented.

CA 22-5

Mr. Ben Thinken, CEO Sports-Pro Athletics

Dear Mr. Thinken:

You recently contacted me about several accounting changes made at Sports-Pro Athletics, Inc. in 2007. This letter details how you should account for each change.

Your change from one method of depreciation to another constitutes a change in accounting estimate effected by a change in accounting principle. A change in estimate employs the current and prospective approach by reporting current and future financial statements on the need basis. Prior periods financial statements are presented as previously reported.

Your change in salvage values for your office equipment is considered a change in estimate. This type of change does not really affect previous financial statements and is thus accounted for currently and prospectively. The change is included in the most current period being reported. There is no need to restate prior periods' financial statements.

Finally, your change in specific subsidiaries results in a change in reporting entity which must be reported by restating the financial statements for all periods presented. The effect of this change should be shown on income before extraordinary items, net income, and earnings per share amounts. In addition, you must disclose in a footnote the nature of the change as well as the reasons for it.

I hope that this information helps you account for the various changes which have taken place at Sports-Pro Athletics. If you need further information, please contact me.

Sincerely,

CA 22-6

- (a) The ethical issues are the honesty and integrity of Usher's financial reporting practices versus the Corporation's and the accounting manager's profit motives. Shortening the life of fixed assets from 10 to 6 years may be evidence that depreciation expenses during the first five years were understated. Such a practice distorts Usher's operating results and misleads users of Usher's financial statements. If this practice is intentional, it is unethical.
- (b) The primary stakeholders in the above situation include Usher's stockholders and creditors. Frain and his auditing firm are stakeholders because they know of the depreciation practices at Usher.
- (c) Frain should report his finding to the partner-in-charge of the Usher engagement. If this practice is deemed to be intentional and fraudulent, then Frain's firm has a professional responsibility to report this incident to the highest levels of management within Usher (the Audit Committee of the Board of Directors).

FINANCIAL REPORTING PROBLEM

(a) New Pronouncements and Reclassifications

No new accounting pronouncements issued or effective during the fiscal year have had or are expected to have a material impact on the financial statements. Certain reclassifications of prior years' amounts have been made to conform to the current year presentation.

(b) Use of Estimates

Preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP) requires management to make estimates and assumptions that affect the amounts reported in the Consolidated Financial Statements and accompanying disclosures. These estimates are based on management's best knowledge of current events and actions the Company may undertake in the future. Estimates are used in accounting for, among other items, consumer and trade promotion accruals, pensions, post-employment benefits, stock options, useful lives for depreciation and amortization, future cash flows associated with impairment testing for goodwill and long-lived assets, deferred tax assets, potential income tax assessments and contingencies. Actual results may ultimately differ from estimates, although management does not believe such changes would materially affect the financial statements in any individual year.

COMPARATIVE ANALYSIS CASE

THE COCA-COLA COMPANY VS. PEPSICO, INC.

(a) and (c) for Coca-Cola Company:

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

During 2004, the FASB issued FASB Staff Position 106-2, “Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003” (“FSP 106-2”). FSP 106-2 relates to the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the “Act”) signed into law in December 2003. The Act introduced a prescription drug benefit under Medicare known as “Medicare Part D.” The Act also established a federal subsidy to sponsors of retiree health care plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. During the second quarter of 2004, our Company adopted the provisions of FSP 106-2 retroactive to January 1, 2004. The adoption of FSP 106-2 did not have a material impact on our consolidated financial statements. Refer to Note 14.

In October 2004, the American Jobs Creation Act of 2004 (the “Jobs Creation Act”) was signed into law. The Jobs Creation Act includes a temporary incentive for U.S. multinationals to repatriate foreign earnings at an effective 5.25 percent tax rate. Such repatriations must occur in either an enterprise’s last tax year that began before the enactment date, or the first tax year that begins during the one-year period beginning on the date of enactment.

FASB Staff Position 109-2, “Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004” (“FSP 109-2”), indicates that the lack of clarification of certain provisions within the Jobs Creation Act and the timing of the enactment necessitate a practical exception to the SFAS No. 109, “Accounting for Income Taxes,” (“SFAS No. 109”) requirement to reflect in the period of enactment the effect of a new tax law. Accordingly, an enterprise is allowed time beyond the financial reporting period of enactment to evaluate the effect of the Jobs Creation Act on its plan for reinvestment or repatriation of foreign earnings. FSP 109-2 requires that the provisions of SFAS No. 109 be applied as an enterprise decides on its plan for reinvestment or repatriation of its unremitted foreign earnings.

COMPARATIVE ANALYSIS CASE (Continued)

In 2004, our Company recorded an income tax benefit of approximately \$50 million as a result of the realization of certain tax credits related to certain provisions of the Jobs Creation Act not related to repatriation provisions. Our Company is currently evaluating the details of the Jobs Creation Act and any impact it may have on our income tax expense in 2005. Refer to Note 15.

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs, an amendment of Accounting Research Bulletin No. 43, Chapter 4." SFAS No. 151 requires that abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) be recorded as current period charges and that the allocation of fixed production overheads to inventory be based on the normal capacity of the production facilities. SFAS No. 151 is effective for our Company on January 1, 2006. The Company does not believe that the adoption of SFAS No. 151 will have a material impact on our consolidated financial statements.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share Based Payment" ("SFAS No. 123(R)"). SFAS No. 123(R) supercedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," and amends SFAS No. 95, "Statement of Cash flows." Generally, the approach in SFAS No. 123(R) is similar to the approach described in SFAS No. 123. SFAS No. 123(R) must be adopted by our Company by the third quarter of 2005. Currently, our Company uses the Black-Scholes-Merton formula to estimate the value of stock options granted to employees and is evaluating option valuation models, including the Black-Scholes-Merton formula, to determine with model the Company will utilize upon adoption of SFAS No. 123(R). Our Company plans to adopt SFAS No. 123(R) using the modified-prospective method. We do not anticipate that adoption of SFAS No. 123(R) will have a material impact on our Company's stock-based compensation expense. However, our equity investees are also required to adopt SFAS No. 123(R) beginning no later than the third quarter of 2005. Our proportionate share of the stock-based compensation expense resulting from the adoption of SFAS No. 123(R) by our equity investees will be recognized as a reduction to equity income.

COMPARATIVE ANALYSIS CASE (Continued)

In December 2004, the FASB issued SFAS No. 153, “Exchanges of Non-monetary Assets, an amendment of APB Opinion No. 29.” SFAS No. 153 is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. APB Opinion No. 29, “Accounting for Nonmonetary Transactions,” provided an exception to its basic measurement principle (fair value) for exchanges of similar productive assets. Under APB Opinion No. 29, an exchange of a productive asset for a similar productive asset was based on the recorded amount of the asset relinquished. SFAS No. 153 eliminates this exception and replaces it with an exception of exchanges of nonmonetary assets that do not have commercial substance. SFAS No. 153 is effective for our Company as of July 1, 2005. The Company will apply the requirements of SFAS No. 153 prospectively.

(b) and (c) for PepsiCo, Inc.: No accounting changes reported.

RESEARCH CASES

CASE 1

Answers will vary among students based on the sources used and the companies selected.

CASE 2

- (a) A change in an estimate is simply a change in the way an individual perceives the realizability of an asset or liability. Perceptions change due to changes in the environment or in other conditions surrounding application of accounting. Examples of changes in estimate are: (1) change in the realizability of trade receivables, (2) revisions of estimated lives, and (3) changes in estimates of warranty costs. An error results from incorrect application of accounting rules to transactions, such as failure to record assets or expenses or ignoring salvage value in computing depreciation. Thus, rather than a change in conditions surrounding appropriate application of accounting rules, an error reflects incorrect application of the rules, given the conditions.
- (b) The accounting for a change in estimate and an error reflects these distinctions. Changes in estimates are handled prospectively. Thus, no adjustments are made to prior reported amounts and the new estimates are applied in current and future periods. Disclosure of the changes is made in the year of the change. A correction of an error in previously issued financial statements should be handled as a prior-period adjustment. Thus, such an error should be reported in the year that it is discovered as an adjustment to the beginning balance of retained earnings. And, if comparative statements are presented, the prior periods affected by the error should be restated. The disclosures need not be repeated in the financial statements of subsequent periods.

As discussed in the article, by increasing the residual value Xerox would have higher profits on each lease (because the sale price will be higher). By reporting the change as an error, Xerox would be able to restate its prior statements to show higher income and increase retained earnings. The change in estimate would not allow restatement of prior periods. The change in residual value resulting in any gain would be recognized only at the termination of the lease.

RESEARCH CASES (Continued)

- (c) Yes, the SEC's position is supported in the literature. According to FASB SFAS No. 13 and Technical Bulletin 79-14 (FTB 79-14), residual values may not be adjusted. Quoting from FTB79-14, Par. 2:

“Paragraphs 17(d), 18(d), and 46 of Statement 13 require the lessor to review annually the estimated residual value of sales-type leases, direct financing leases, and leveraged leases, respectively. Those paragraphs also contain a provision that prohibits any upward adjustment of the estimated residual value. The prohibitions of paragraphs 17(d), 18(d), and 46 of Statement 13 against upward adjustments to the leased property's estimated residual value are equally applicable to the guaranteed portion. If a lease initially transferred substantially all of the benefits and risks incident to the ownership of the leased property, it would not seem appropriate that the lessor could subsequently increase the benefits that were accounted for as having been retained initially.”

PROFESSIONAL RESEARCH: FINANCIAL ACCOUNTING AND REPORTING

Search Strings: “effected by a change;” “change in estimate;” “change in accounting principle” and “depreciation”

- (a) According to *SFAS No. 154*, Par. 2.e., a change in accounting estimate effected by a change in accounting principle reflects a change in accounting estimate that is inseparable from the effect of a related change in accounting principle. An example of a change in estimate effected by a change in principle is a change in the method of depreciation, amortization, or depletion for long-lived, nonfinancial assets. Such changes in accounting principles should be accounting for as a change in estimate, as discussed in *FAS154*, Par. 19:

A change in accounting estimate shall be accounted for in (a) the period of change if the change affects that period only or (b) the period of change and future periods if the change affects both. A change in accounting estimate shall not be accounted by restating or retrospectively adjusting amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods.

- (b) According to *SFAS No. 154*, Par. 21: Like other changes in accounting principle, a change in accounting estimate that is effected by a change in accounting principle may be made only if the new accounting principle is justifiable on the basis that it is preferable. For example, an entity that concludes that the pattern of consumption of the expected benefits of an asset has changed, and determines that a new depreciation method better reflects that pattern, may be justified in making a change in accounting estimate effected by a change in accounting principle.
- (c) As explained in *FAS154*, Par. 20, the FASB notes that:

“Distinguishing between a change in an accounting principle and a change in an accounting estimate is sometimes difficult. In some cases, a change in accounting estimate is effected by a change in accounting principle. One example of this type of change is a change in method of depreciation, amortization, or depletion for long-lived, nonfinancial assets (hereinafter referred to as depreciation method). The new depreciation method is adopted in partial or complete recognition of a change in the estimated future benefits inherent in the asset, the pattern of consumption of those benefits, or the information available to the entity about those benefits. The effect of the change in accounting principle, or the method of applying it, may be inseparable from the effect of the change in accounting estimate. Changes of that type often are related to the continuing process of obtaining additional information and revising estimates and, therefore, are considered changes in estimates for purposes of applying this Statement.

Furthermore, in the Basis of Conclusions for *FAS154* (Par. B24–B25). The Board noted that it carried forward without reconsideration the general provisions in **APB Opinion 20** related to a change in accounting estimate. Those provisions are consistent with the requirements of international accounting standards (IFRS), with the exception that IFRS requires a change in the method of depreciation of amortization for a long-lived, nonfinancial asset to be reported as a change in estimate. The Board noted that the information an entity would need to establish a basis for changing the depreciation, amortization, or depletion method for a long-lived, nonfinancial asset (hereinafter described as a change in depreciation method) would be obtained by continued observation of actual use of the expected benefits of the asset as compared to previous estimations of the pattern of consumption that formed the basis for the initial method. Thus, during initial deliberations, the Board concluded that a change in depreciation method is a change in estimate effected by a change in accounting principle. That decision was affirmed in redeliberations, the Board noted that because it is a change in estimate, a change in depreciation method should not be accounted for by retrospective application to prior periods. However, appropriate disclosures should be required for the change in accounting principle that effected the change in estimate. Thus, the Board decided that a change in estimate effected by a change in accounting principle should be subject to the same requirement to justify the change in principle on the basis that the new principle is preferable. Most respondents to the Exposure Draft agreed with the Board’s initial decision.”

PROFESSIONAL SIMULATION

Journal Entries

(a) Inventory.....	18,000*	
Retained Earnings		18,000

*(\$20,000 + \$24,000 + \$27,000) – (\$15,000 + \$18,000 + \$20,000)

(b) Inventory.....	28,000*	
Retained Earnings		28,000

*(\$20,000 + \$24,000 + \$27,000) – (\$12,000 + \$14,000 + \$17,000)

Financial Statements

Computation of EPS for 2008

Basic EPS

Net income	\$30,000	
Outstanding shares	10,000	
Basic EPS	<u>\$3.00</u>	(\$30,000 ÷ 10,000)

Diluted EPS

Net income	\$30,000	
Add: Interest savings (\$200,000 X 6%)	<u>12,000</u>	
Adjusted net income	<u>\$42,000</u>	
Adjusted net income	\$42,000	
Outstanding shares	10,000	
Shares upon conversion	6,000*	
Diluted EPS	<u>\$2.63</u>	(\$42,000 ÷ 16,000)

*\$200,000 ÷ \$1,000 = 200 bonds; 200 bonds X 30 = 6,000 shares

PROFESSIONAL SIMULATION (Continued)

Computation of EPS for 2007

Basic EPS

Net income	\$27,000	
Outstanding shares	10,000	
Basic EPS	<u>\$2.70</u>	(\$27,000 ÷ 10,000)

Diluted EPS

Net income	\$27,000	
Add: Interest savings (\$200,000 X 6%)	<u>12,000</u>	
Adjusted net income	<u>\$39,000</u>	
Adjusted net income	\$39,000	
Outstanding shares	10,000	
Shares upon conversion	6,000	
Diluted EPS	<u>\$2.44</u>	(\$39,000 ÷ 16,000)

EPS Presentation

	<u>2008</u>	<u>2007</u>
Net income	<u>\$30,000</u>	<u>\$27,000</u>
Basic EPS	<u>\$ 3.00</u>	<u>\$ 2.70</u>
Diluted EPS	<u>\$ 2.63</u>	<u>\$ 2.44</u>