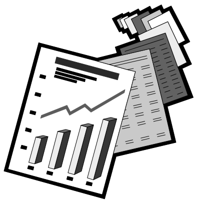
Accounting Changes and Error Analysis

Chapter

22



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MATERIALITY!!!!

Everything ever must be <u>material</u> to matter. Consequently, remember that for this whole class, we assume the items we discuss are material to the Company.

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Accounting Changes - APBO No. 20

Classifications:

a. Change in Accounting Principle --
  - GAAP to GAAP change
    » NEW literature: FASB Statement No.154.

b. Change in Accounting Estimate --
  - Example = useful lives of fixed assets

c. Change in Reporting Entity --
  - Example = changing specific subsidiaries in consolidated financial statements.

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Change in Principle

- Change from one GAAP to another GAAP
- A change is <u>NOT</u> considered to result when a new principle is adopt in recognition of events that have occurred for the <u>first</u> time or that were were previously <u>immaterial</u>.
- Change from non GAAP to GAAP is not an accounting changes but rather considered a

  Correction of an Error
- NOTE: When it is difficult to determine if it is a change in estimate or a change in principle (such as change in depreciation method), GAAP requires that it be treated as a change in estimate (Current & Forward).

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Change in Principle

Enterprise must demonstrate that the new GAAP is *preferable* to the existing one.

Three POSSIBLE Approaches for Reporting Changes:

- Retroactive (adjust prior years)
- Currently (adjust current year)
- Prospective (adjust current and future years)

WHICH DO WE USE?

For years and years, we used the "Cumulative effect" method, but that recently changed (Due to IAS "Convergence". GAAP requires the retrospective approach, which is WHAT YOU LEARNED IN 136A!!!!!

- Report each year presented as if the new principle had always been in place
- For the very first year presented, make sure to adjust the balance sheet accounts (including retained earnings) for the cumulative effect up to that point!

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CHANGE IN ACCOUNTING PRINCIPLE EXAMPLE

In 2009, the company changes their inventory costing principle from FIFO to weighted average. They have a 35% effective tax rate and began business in 2003. Assume they have not recorded COGS for 2009 yet.

	COGS Recorded (FIFO)	COGS If used Wtd Average
2003	10,000	11,000
2004	12,000	13,000
2005	18,000	15,000
2006	15,000	18,000
2007	16,000	12,000
2008	10,000	15,000
CUMULATIVE EFFECT	81,000	84,000
2009	17,000	15,000
TOTAL THRU 09'	98,000	99,000

COGS recorded through end of 2008	81,000
COGS if using wtd average over the same period	84,000
Cumulative effect through 12/31/08	3,000

TO GET BEGINNING BALANCES RIGHT (Catch-up 2003-2008):

Beginning retained earnings	1,950	
Tax effect	1,050	
Inventory		3,000

AMOUNT TO RECORD IN 2009 AND THEREAFTER IS DETERMINED WITH NEW PRINCIPLE

2009 entry		
COGS	15,000	
Inventory		15,000

RECAP. WHAT WE JUST DID:

COGS recorded before we started messing with it:	81,000
Cumulative effect adjustment	3,000
2009 COGS reported	15,000
Hmmm, isnt that the total we would have if we were using the new method all along!!	99,000

CHANGE IN PRINCIPLE, REQUIRED DISCLOSURES:

- The Nature of and reason for the change
- Method of applying the change (i.e retrospective)
  - Description of items that changed and by how much
  - The effect on the following items:
    - » Income from continuing op's
    - » Net income
    - » Any other significant measure, including per share
  - The cumulative effect on retained earnings.

Change in Estimate

Changes are handled Prospectively, since estimates are an inherent part of accounting.

Example --

Change in estimate of salvage value or useful life.

Exercise 22-11

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

Exercise 22-11

(a) Journal entry to correct prior years?

No Entry Necessary

Exercise 22-11

(b) Journal entry to record depreciation in 2005?

Original cost	$510,000
Accum. depreciation ($510,000-10,000)/10x7	(350,000)
Book value	160,000
Salvage value	(5,000)
Depreciable basis	155,000
Remaining life (15-7)	8 years
Depreciation expense	$ 19,375

ENTRY:

Depreciation expense	$19,375	
Accumulated depreciation		$19,375

Change in Reporting Entity

Requires restating the financial statements of all prior periods presented (Retroactively).

Footnotes should describe the nature of the change and the reason for it.

Correction of an Error

APBO No. 20 requires:

(a) treated as prior period adjustments,

(b) recorded in the year in which the error was discovered, and

(c) reported in the F/S's as an adjustment to the beginning balance of Retained Earnings

If comparative statements are presented, the prior statements affected should be restated to correct the error.

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Errors

Can result from:

- Mathematical mistakes, improper estimates, misapplication of accounting principles, etc.

Once discovered, the accountant must determine:

(a) What type of error is involved?

(b) What entries are needed to correct the error?

(c) How are the F/S's to be restated?

Does the error affect B/S, I/S, or both?

ERRORS & RESTATEMENTS

In 1997, there were 116 restatements. In 2002 there were 330 and 323 in 2003!!!!!!!

- Prevalence clearly growing!
  - Many argue that this is a one-time issue of fixing old problems.
  - I disagree. The Public Company Accounting Oversight Board (PCAOB) is closely reviewing public companies and have an OBVIOUS goal: Identify restatements
- Top two causes: #1 reserves and contingencies, #2 Revenue recognition– say hello chapter 18 to the REAL WORLD!!!

ERROR EXAMPLE

Company Eye Dunnonada, Inc. was not properly reporting revenue from a pool of notes receivable they owned. This had been going on since 1972. Their effective tax rate is 35%. Their analysis is:

Tax rate	35%		
	Overstated/ (Understated)		
	Pretax effect of errors	**Tax effect**	**Tax effected**
Prior to 2002	100,000	35,000	65,000
2002	10,000	3,500	6,500
2003	(5,000)	(1,750)	(3,250)
2004	(5,000)	(1,750)	(3,250)

ERROR EXAMPLE

- **What are the journal entries for 2004, 2003 and 2002, respectively to properly fix the error? (assume that the basis in the note pool is the location of the problem on the balance sheet and interest income is the location of the problem on the income statement)**
- **Based on recording the proper adjustments and including this impact in the tax provision, proper net income in 2004, 2003 and 2002 is $275,000, $200,000 and $280,000, respectively.**
- **Present the 3 year statement of retained earnings assuming that the retained earnings at the beginning of 2002 (prior to any restatements) was $1,275,000.**

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ERROR EXAMPLE SOLUTION

Tax rate	35%		
	Overstated/ (Understated)		
	Pretax effect of errors	**Tax effect**	**Tax effected**
Prior to 2002	100,000	35,000	65,000
2002	10,000	3,500	6,500
2003	(5,000)	(1,750)	(3,250)
2004	(5,000)	(1,750)	(3,250)

2002 ENTRY TO FIX BEGINNING RETAINED EARNINGS

Beginning retained earnings	65,000	
Notes receivable		100,000
Deferred taxes	35,000	

2002 ENTRY TO RECORD PROPERLY*

Interest income	10,000	
Notes receivable		10,000

2003 ENTRY TO RECORD PROPERLY*

Notes receivable	5,000	
Interest income		5,000

2004 ENTRY TO RECORD PROPERLY*

Notes receivable	5,000	
Interest income		5,000

* NOTE that as the "fix" occurs in the income statement before the income tax provision, these entries do not need to be tax effected- the tax provision will take this into account automatically.

ERROR EXAMPLE- RETAINED EARNINGS PRESENTATION

Idunnonada, Inc.
Statements of Retained Earnings

Retained earnings as of January 1, 2002, as previously reported	1,275,000
Correction of an error, see note X, net of $35,000 tax effect	(65,000)
Retained earnings as of January 1, 2002, as RESTATED	1,210,000
Net income 2002 Restated, see note x	280,000
Retained eanrings at December 31, 2002	1,490,000
Net income 2003 Restated, see note x	200,000
Retained eanrings at December 31, 2003	1,690,000
Net income 2004	275,000
Retained earnings at December 31, 2004	1,965,000

Problem 23-6, pg. 1261
10. Insurance expense 5,000
Prepaid insurance 7,500
Retained earnings 12,500
11. Amortization expense 1,250
Retained earnings 1,250
Trademark 2,500
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