Accounting Changes and Error Analysis

Chapter 22

MATERIALITY!!!!
Everything ever must be material to matter. Consequently, remember that for this whole class, we assume the items we discuss are material to the Company.

Accounting Changes - APBO No. 20

Classifications:
- Change in Accounting Principle --
  - GAAP to GAAP change
    » NEW literature: FASB Statement No.154.
- Change in Accounting Estimate --
  - Example = useful lives of fixed assets
- Change in Reporting Entity --
  - Example = changing specific subsidiaries in consolidated financial statements.

Change in Principle
- Change from one GAAP to another GAAP
- A change is NOT considered to result when a new principle is adopt in recognition of events that have occurred for the first time or that were were previously immaterial.
- 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).
Enterprises 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 retroactive 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!

**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.

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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.

(a) Journal entry to correct prior years?
No Entry Necessary

(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?

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**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:

<table>
<thead>
<tr>
<th>Tax rate</th>
<th>35%</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Pretax effect of errors</th>
<th>Tax effect</th>
<th>Tax effected</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prior to 2002</td>
<td>100,000</td>
<td>35,000</td>
</tr>
<tr>
<td>2002</td>
<td>10,000</td>
<td>3,500</td>
</tr>
<tr>
<td>2003</td>
<td>(5,000)</td>
<td>(1,750)</td>
</tr>
<tr>
<td>2004</td>
<td>(5,000)</td>
<td>(1,750)</td>
</tr>
</tbody>
</table>

ERROR EXAMPLE SOLUTION

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):

- 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 earnings at December 31, 2002 1,490,000
Net income 2003 Restated, see note X 200,000 Retained earnings at December 31, 2003 1,690,000
Net income 2004 275,000 Retained earnings at December 31, 2004 1,965,000