

Chapter 23

Accounting Changes and Error Analysis

LECTURE OUTLINE

The material in this chapter can be covered in two or three class periods. Students are better able to differentiate the various types of accounting changes if the journal entries and reporting of each type are demonstrated.

A. Types of Accounting Changes.

1. Change in Accounting Principle.
2. Change in Accounting Estimate.
3. Change in Reporting Entity.
4. Error Correction **is not** classified as an accounting change.

B. Changes in Accounting Principle.

1. Involves a change from one generally accepted accounting principle to another generally accepted accounting principle. **Example:** Change from the straight-line method of depreciation to the sum-of-years'-digits method.
2. A change is **not** considered to result when a new principle is adopted in recognition of events that have occurred for the **first** time or that were previously **immaterial**. **Example:** Capitalizing leases whereas previously leases were not capitalized because they were not material.

3. If the accounting principle previously followed was **not** acceptable, or if the principle was applied **incorrectly**, a change to a generally accepted accounting principle is considered a **correction of an error**. **Example:** Change from capitalizing research and development to expensing it.

4. Changes in accounting principle are considered appropriate only when the enterprise demonstrates that the alternative generally accepted accounting principle is preferable to the existing one.

5. Three approaches for reporting such changes have been considered:
 - a. **Retroactively:** A retroactive adjustment of previous years' financial statements is made.
 - b. **Currently:** The cumulative effect of the new method is computed and reported in the current year's income statement.
 - c. **Prospectively:** No change is made in previously reported results. Effects of change are "spread out" over current and future years.

6. **Cumulative-Effect Type Accounting Change.** In general, changes in accounting principle are treated as follows:

Teaching Tip

Illustration 23-1 provides a numerical example of a cumulative-effect type accounting change when a company changes from the sum-of-the-years-digits to the straight-line method of depreciation.

- a. The current approach is employed.
- b. The cumulative effect of the change is reported in the income statement in a separate category, net of taxes, between extraordinary items and net income.

- c. Prior financial statements are not altered.
 - d. Income before extraordinary items and net income computed on a pro forma basis are presented as if the new principle had been applied during all periods affected.
7. **Retroactive-Effect Type Accounting Change:** In five special situations, the change in principle must be handled retroactively. These situations are:
- a. A change from the LIFO method.
 - b. A change in accounting for long-term construction-type contracts.

Teaching Tip

Illustration 23-2 provides a numerical example of a retroactive-effect type accounting change when a company changes from the completed contract to percentage-of-completion method for long-term contracts.

- c. A change to or from the "full-cost" method of accounting in the extractive industries.
 - d. Issuance of financial statements by a company for the first time to obtain additional equity capital, to effect a business combination, or to register securities.
 - e. Requirement by a professional pronouncement.
8. **Change to the LIFO method:** In such a situation, the base-year inventory for all subsequent LIFO calculations is the opening inventory in the year the method is adopted. Disclosure is limited to showing the effect of the change on the results of operations in the period of change. This is largely because of the number of assumptions that would be required to compute the effect of the change.

- C. Change in Accounting Estimate: Such changes are handled prospectively since estimates and their revision are an inherent part of accounting. **Example:** Changes in estimates of salvage value or useful life.
1. 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. **Example:** Change from capitalizing an asset to expensing it because the estimate of useful life changes to less than a year.
 2. Careful estimates that later prove incorrect should be considered changes in estimate and not errors.
- D. Change in Reporting Entity: Such changes should be reported by restating the financial statements of all prior periods presented. **Example:** Presenting consolidated statements in place of statements of individual companies.
- E. Correction of an Error: Corrections of errors should be handled as prior period adjustments. **Example:** Making mathematical error in the determination of a prior period's depreciation expense.

Teaching Tip

Illustration 23-3 provides a summary of accounting changes and correction of errors.

- F. Management's Motivation for Accounting Changes.
1. Political costs: The larger the company, the more likely it is to adopt income decreasing approaches in selecting accounting methods.
 2. Capital structure: Companies with high debt-to-equity ratios are more likely to select accounting methods that will increase net income.

3. Bonus payments: Management will select accounting methods that maximize income, if their bonuses are tied to income.
4. Smooth earnings: In order to avoid attraction; the attention of politicians, regulators, and competitors companies sometimes chose accounting methods that provide gradual increases in income.

G. Error Analysis.

1. Balance Sheet Errors. Only affect assets, liabilities, and stockholders' equity: **Example:** A misclassification of an asset.
2. Income Statement Errors. Only affect revenues and expenses. **Example:** a misclassification of a revenue account.
3. Balance Sheet and Income Statement Effect.
 - a. **Counterbalancing errors** are those that will be offset or corrected over two periods. **Example:** Errors with respect to inventory.
 - (1) If the books have been closed:
 - (a) No entry necessary, if error already counterbalanced.
 - (b) If error not yet counterbalanced, need entry to adjust retained earnings.
 - (2) If the books have not been closed:

- (a) If error already counterbalanced and company is in second year, need entry to adjust the beginning retained earnings balance and to correct the current year.
 - (b) If error not yet counterbalanced, also need entry to correct beginning retained earnings balance and correct the current period.
- (3) If comparative statements presented, restatement of the amounts is necessary even if a correcting entry is not required.

Teaching Tip

Illustration 23-4 provides a numerical example of a counterbalancing error when a company fails to accrue wages at year-end. **Illustration 23-5** can be used to show the difference between counterbalancing and noncounterbalancing errors.

- b. **Noncounterbalancing errors** are those that take longer than two periods to correct themselves or never correct themselves. **Example:** Errors with respect to depreciation.
- (1) Correcting entries are needed, even if the books have been closed.