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Having fun correcting errors in financial accounting!

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HAVING FUN CORRECTING ERRORS in FINANCIAL ACCOUNTING!

Students in Intermediate Accounting courses often have considerable difficulty with journal entries to correct errors even though most of the journal entries are no more profound than what they should have learned in the first introductory financial accounting course. What follows are typical errors I ask my students to correct. Then, I include the corresponding correcting journal entries that they are expected to prepare.

This topic is generally taught in the Intermediate II course within the context of the textbook chapter on Accounting Changes in Principle, Estimates, and Errors. Most textbooks do not treat this subject adequately given the problems students encounter with error corrections. At the start of this topic, I encourage students to first write down the wrong or omitted journal entry, then the correct entry, and finally the correcting entry. Once they become accustomed to doing these corrections, the students enjoy the critical thinking involved in the error correction process. The assumption is that the books close at the end of the year.

1. You put the cost of ordinary repairs in the Equipment account in Year 1. You find the error in Year 3. Make the necessary correcting entries.

Yr. 1

Correct entry

Dr. Repairs Expense

Cr. Cash

Wrong entry

Dr. Equipment

Cr. Cash

Yr. 3

Correcting entry (entries)

Dr. Repairs Expense

Cr. Equipment

Observe that the correcting entry is not the same as the correct entry. Also notice that there is nothing wrong with the cash in the “wrong entry.”

2. You failed to amortize Patents in Year 1. You are now in Year 2.

Yr. 1 entry

What is it? The following entry was omitted:

Dr. Amortization Expense on Patents
Cr. Patents

Correcting Yr. 2 entry

What is it?

Dr. Retained Earnings
Cr. Patents

Observe that we cannot use the expense account in Year 2 to correct the error in Expense account in Year 1, which is closed. Otherwise, we would be contaminating Year 2's Amortization expense account with Year 1's expense.

3. You failed to take 5,000 depreciation expense in Year 2 but took 2,000 too much in Year 3. You find these errors upon sale of the equipment in Year 3.

What are the correcting entries?

Dr. Retained Earnings 5,000
Cr. Accumulated Depreciation 5,000
Dr. Accumulated Depreciation 2,000
Cr. Depreciation Expense 2,000

Notice that the first error called for a prior year's adjustment to correct it, while the second error is corrected using depreciation expense in Year 3's books which are still open.

4. You overstated Accumulated Depreciation at the end of Year 2 by 10,000 and understated this account balance by 3,000 at the end of Year 1. You find these errors (a). In Year 3, b. in Year 4 when you sell the machine in question.

What are the correcting entries?

- a. Dr. Accumulated Depreciation 10,000
Cr. Retained Earnings 10,000
b. Same as 4 a.

Observe that only one correcting entry is called for since the error at the end of Year 1 is embedded in the Accumulated Depreciation account at the end of Year 2. The same entry is made whether the errors are found in Year 3 or Year 4. Such errors dealing with long-term accounts are NOT potentially counterbalancing from year to year correcting Retained Earnings in the process, contrary to errors in short-term accounts such as expenses, revenues, and inventory.

5. The ending inventory is over in Years 1 by 1,000, under in Year 2 by 3,000 and under in Year 3 by 6,000.

- a) You find these errors in Year 3.
- b) What if you find the errors in Year 4?
- c) What if you find the errors in Year 5?

What are the correcting entries?

- a. The ending inventory overage in Year 1, reduces cost of goods sold and raises net income in that year. It is counterbalanced by the same error in beginning inventory in Year 2, which raises cost of goods sold and lowers net income in that year. This means that Retained Earnings is correct by the beginning of Year 3 for those errors. The 3,000 error in Year 2 raises cost of goods sold, lowers net income and Retained Earnings, and lowers beginning inventory in Year 3. This is the correcting entry:

Dr. Beginning Inventory	3,000	
	Cr. Retained Earnings	3,000

The ending inventory error in Year 3 also means this correcting entry is needed:

Dr. Ending Inventory	6,000	
	Cr. Cost of Goods Sold.	6,000

- b. No entry is called for the 1,000 and 3,000 errors since the Retained Earnings effects from both errors are counterbalanced from Years 1 to 2 and 2 to 3. However, manual adjustments are needed to correct inventories, cost of goods sold, and Retained Earnings in previous financial statements. For the 6,000 error, which understates beginning inventory in Year 4, this correcting entry is needed:

Dr. Beginning Inventory	6,000	
	Cr. Retained Earnings	6,000

- c. There is no correcting journal entry since each of the ending inventory errors was counterbalanced with the subsequent beginning inventory errors, leaving Retained Earnings correct. However, manual adjustments to errors in inventory, cost of goods sold, and net income figures are needed to correct those figures in the prior financial statements with or without correcting journal entries.

6. Purchases are under and so is the ending inventory by the same amount in Year 2.
- You find this error in Year 3.
 - What if you find the error in Year 4?

What are the correcting entries?

- Dr. Beginning Inventory
 Cr. Accounts Payable
- No correcting journal entry

Observe in (a) there is no income or Retained Earnings error since the purchases and ending inventory are over by the same amount, making cost of goods sold and net income correct. Therefore, Retained Earnings is not involved in the correcting entry. In (b), the effect of the lower ending inventory in Year 2, also reduces net income. This is offset by the under reporting of beginning inventory in Year 3. Once the books are closed there is no Retained Earnings error. Manual adjustments to purchases, inventories, cost of goods sold, and Retained Earnings in previous financial statements are needed.

7. The beginning inventory in Year 2 is over by \$4.00, purchases under by \$2.00. The beginning inventory in Year 3 is under by \$1.00, purchases under by \$2.00. The books are closed at the end of the year. What is the correcting entry in Year 3?

Since the beginning inventory in Year 2 is over by \$4, so too is the ending inventory in Year 1. Therefore, the cost of goods sold in Year 1 is under by \$4, net income is over by \$4 as is Retained Earnings at the end of Year 1. In Year 2, the cost of goods available for sale is over by \$2, the ending inventory under by \$1 since beginning inventory in Year 3 is under by \$1, and cost of goods sold in Year 2 is over by \$3. Net income in Year 2 is under by \$3. Therefore, Retained Earnings at the end of Year 2 is over by \$1. The correcting journal entry in Year 3 is:

Dr. Beginning Inventory	1
Dr. Purchases	2
Dr. Retained Earnings	1
Cr. Accounts Payable	4

The credit of 4 to Accounts Payable stems from understating purchases by 4 in Years 2 and 4.

8. Prepaid insurance expense is over at the end of Year 1.
- What if you find this error in Year 2 after quarterly adjusting entries.
 - What happens if you find the error in Year 2 during the closing process?
 - What if you find the error in Year 3?

What are the correcting entries?

- a. Dr. Retained Earnings
 Cr. Insurance Expense
- b. Dr. Retained Earnings
 Cr. Income Summary
- c. o correcting journal entry

Observe that the correcting entry varies here depending on when you capture the error. You cannot credit Prepaid Expense in (a) since the discovery of the error occurred after quarterly adjusting entries in Year 2. Had you found this error in Year 2 prior to quarterly adjusting entries, then you could have credited Prepaid Expense instead of Insurance Expense. In (b), you need to credit Income Summary because the Year 2 insurance expense account has already been closed to Income Summary by the time you discover the error. In (c), the Retained Earnings account has self-corrected by the time you find the error, since the books for Years 1 and 2 have closed. Therefore, no correcting journal entry can be made. However, even in (c) you would have to go back to Year 1 and Year 2 financial statements to manually correct the errors.