

Solution:

(1)

| | 2011 | 2012 | 2013 |
|-----------------------------------|---------------|---------------|-----------------|
| BEGINNING INVENTORY | Not affected | +\$10 million | Not affected |
| ENDING INVENTORY | +\$10 million | Not affected | -\$5 million |
| COST OF GOODS SOLD | +\$10 million | -\$10 million | -\$5 million |
| GROSS MARGIN | -\$10 million | +\$10 million | +\$5 million |
| COST OF GOODS AVAILABLE | Not affected | +\$10 million | Not affected |
| INCOME BEFORE INCOME TAXES | -\$10 million | +\$10 million | +\$5 million |
| INCOME TAX EXPENSES | -\$4 million | +\$4 million | +\$1.25 million |
| NET INCOME | -\$6 million | +\$6 million | +\$3.75 million |

(2)

Amount of retained earnings is incorrect in 2011 (understated by \$6 million) but becomes corrected in 2012 (no change) and again becomes incorrect in 2013 (overstated by \$3.75 million).