Assignment 3

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**Case 1: Accounting Changes**

a) Changing from the sum-of-year's-digits depreciation method to the straight-line method for fixed assets would be considered a change in accounting estimate. An accounting estimate is an adjustment made to an existing accounting policy to reflect new information or developments. The change in depreciation method involves reassessing the useful lives and depreciation expense calculation for the fixed assets.

**Treatment:**

The change in accounting estimate is applied prospectively, meaning it is implemented in the current and future periods. The effect of the change is not applied retrospectively, which means that previously reported financial statements are not restated. The adjustment is recognized in the current period and does not affect prior periods.

**Permissibility:** The change from the sum-of-year's-digits method to the straight-line method is generally permissible under Generally Accepted Accounting Principles (GAAP) if the change results in a more accurate representation of the financial statements. However, it is important to note that the change should not be made with the intention of manipulating reported results or avoiding negative consequences.

b) If a public company obtains additional information about the service lives of its fixed assets, indicating that the previously used service lives should be shortened, it would be considered a change in accounting estimate as well. This change reflects a revision in the estimate of the asset's useful life.

**Income Statement Treatment:**

The impact of the change in estimate should be recognized in the income statement of the year in which the change occurs. The adjustment should be reflected in the depreciation expense line item, adjusting for the remaining useful life of the affected assets based on the new estimate.

**Disclosure:**

The financial statements or accompanying notes should disclose the nature of the change, the reason for the change, and the financial impact of the change on the current and future periods. The disclosure should provide sufficient information to allow users to understand the implications of the change in estimate on the financial statements and any significant effects on the company's financial position and results of operations

**Case 2: Earnings per Share:**

a) Earnings per Share (EPS) is a financial ratio that represents the portion of a company's profit allocated to each outstanding share of common stock. In a corporation with only one class of common stock, EPS is computed by dividing the net income available to common shareholders by the weighted average number of outstanding common shares during the reporting period. The calculation involves subtracting preferred dividends, if any, from the net income and determining the weighted average number of outstanding common shares. The information about EPS should be disclosed in the financial statements, typically in the income statement or as a separate note, including the numerator (net income available to common shareholders) and the denominator (weighted average number of outstanding common shares).

**b) Treatment of items in computing EPS:**

i. Declaration of current dividends on cumulative preferred stock: Dividends declared on cumulative preferred stock are subtracted from the net income available to common shareholders when calculating EPS because they reduce the amount of income available to be distributed to common shareholders.

ii. Acquisition of outstanding common stock (treasury stock): The acquisition of outstanding common stock (classified as treasury stock) does not affect the EPS calculation. Treasury stock is considered a reduction of outstanding shares, and the weighted average number of outstanding common shares is adjusted accordingly.

iii. Two-for-one stock split of common stock: A two-for-one stock split does not impact the total value of common shareholders' equity or the net income. The split increases the number of outstanding common shares while proportionally decreasing their value. The weighted average number of outstanding common shares is adjusted accordingly in the EPS calculation.

iv. Exercise of a common stock option issued at a price below market value but above book value: The exercise of a common stock option does not directly impact the EPS calculation. However, if the option was exercised at a price below market value, the incremental shares issued may be dilutive and could affect the diluted EPS calculation. Diluted EPS reflects the potential impact of securities that could be converted into common shares.

**Case 3: Identifying Accounting Changes:**

**Situation 1:**

a) Type of accounting change: Change in accounting estimate.

b) Manner of reporting the change under current GAAP: Under current GAAP, a change in accounting estimate is applied prospectively. The company would adjust the depreciable lives of its fixed assets at the beginning of the current year. The revised depreciable lives will be used to calculate depreciation expense going forward, but there is no need to restate prior periods.

c) Effects of change on the statement of financial position and earnings statement:

\*Statement of Financial Position (Balance Sheet): The carrying amounts of the fixed assets will be adjusted based on the revised depreciable lives. The accumulated depreciation will also be adjusted accordingly, reflecting the change in estimate.  
\*Earnings Statement (Income Statement): The change in accounting estimate will impact the depreciation expense calculation for the current year and future years. The depreciation expense will be higher in the current year due to the reduced depreciable lives, resulting in lower net income.

Situation 2:

a) Type of accounting change: Change in accounting principle.

b) Manner of reporting the change under current GAAP: Under current GAAP, a change in accounting principle is typically accounted for retrospectively. The company would adjust the financial statements of prior periods as if the new accounting principle had always been applied. The adjustment is made to the opening balance of retained earnings in the earliest period presented.

c) Effects of change on the statement of financial position and earnings statement:

\*Statement of Financial Position (Balance Sheet): The carrying amounts of the plant equipment will not be adjusted since the change is related to the depreciation method. However, the accumulated depreciation will be adjusted based on the new depreciation method.

\*Earnings Statement (Income Statement): The change in accounting principle will impact the depreciation expense calculation for both new acquisitions and previously acquired plant equipment. The depreciation expense will be lower under the straight-line method compared to the previous accelerated basis, leading to changes in net income for the current year and subsequent years.