

Exercise 14-16

Wilkins Food Products, Inc., acquired a packaging machine from Lawrence Specialists Corporation. Lawrence completed construction on the machine on January 1, 2019. In payment for the machine, Wilkins issued a three-year installment note to be paid in three equal payments at the end of each year. The payments include interest at the rate of 10%.

Lawrence made a conceptual error in preparing the amortization schedule, which Wilkins failed to discover until 2021. The error had caused Wilkins to understate interest expense by \$45,000 in 2019 and \$40,000 in 2020.

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Exercise 14-16 (continued)

**Part 1:** Determine which accounts are incorrect as a result of these errors at January 1, 2021, before any adjustments. Explain your answer. (Ignore income taxes)

Assume that the amount of cash paid on December 31, 2019 and December 31, 2020 is correct. Therefore:

2019: Interest expense understated by \$45,000 → Net Income overstated by \$45,000 → Retained earnings overstated by \$45,000; Notes Payable is understated by \$45,000.

2020: Interest expense understated by \$40,000 → Net Income overstated by \$40,000 → Retained earnings overstated by \$85,000 (\$45,000 + \$40,000); Notes Payable is understated by \$85,000 (\$45,000 + \$40,000)

**Part 2:** Prepare a journal entry to correct the error.

Retained earnings	85,000	
Notes Payable		85,000

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Exercise 14-16 (continued)

**Part 3:** What other step(s) would be taken in conjunction with the error?

This is a prior period adjustment, meaning that the financial statements in 2019 and 2020 were incorrect. In addition to the correcting entry, the 2019 and 2020 financial statements would be retrospectively restated to report the correct amount of interest expense, net income, retained earnings, and notes payable if they are presented with 2021 for comparative purposes. Also, a disclosure note would be required in 2021 describing the nature of the error, and the impact of the correction on the prior years' net income and related earnings per share.

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