Chapter 4

The Adjustment Process and Financial Statements

Business Background: The Accounting Cycle

Start of the Accounting Period

Phase 1: During the Accounting Period.

- Perform transaction analysis.
- Record journal entries.
- Post amounts to general ledger.

Phase 2: End of the Accounting Period.

- Prepare a trial balance.
- Record and post adjusting entries.
- Prepare financial statements.
- Record and post closing entries.

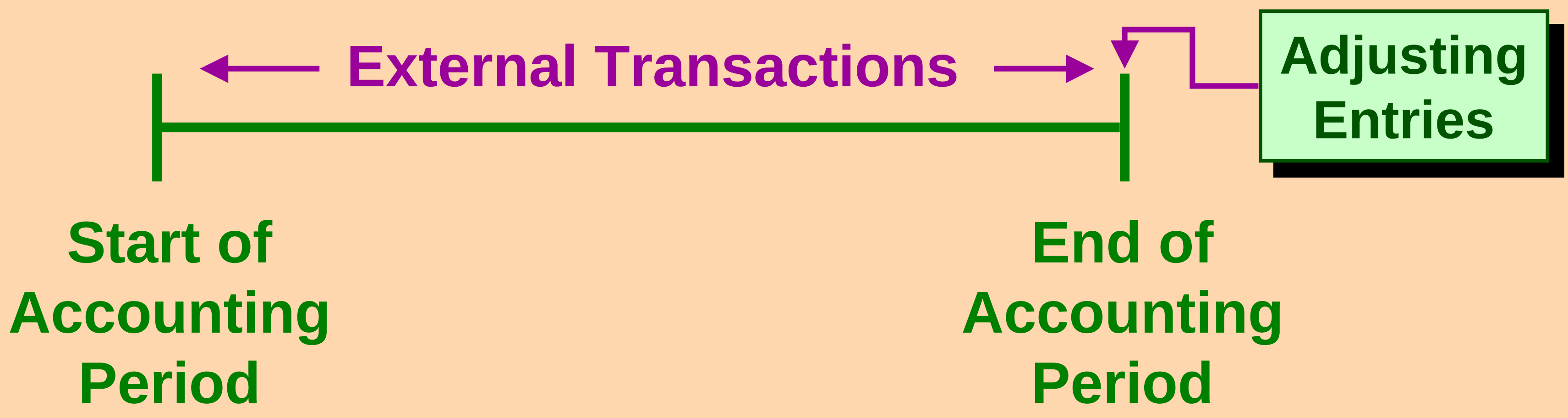
End of the Accounting Period

Business Background

As indicated in Phase 1 of the Accounting Cycle, *external* transactions between the business and other *external* parties are recorded during the period as they occur.

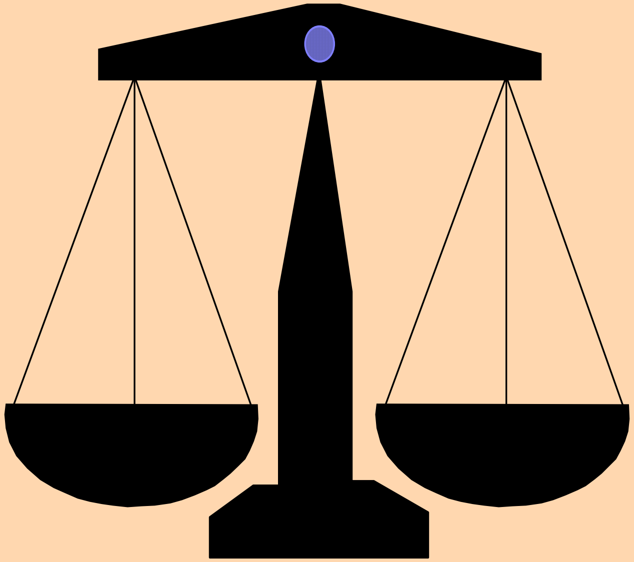
Business Background

At the end of the accounting period, adjusting journal entries are recorded for internal transactions that have a direct and measurable effect on the accounting entity, particularly for revenue and expense recognition.



The Unadjusted Trial Balance

- **A listing of individual accounts, usually in financial statement order.**
- **Ending debit or credit balances are listed in two separate columns.**
- **Total debit account balances *should* = total credit account balances.**



SPENCER, INC.
Unadjusted Trial Balance
December 31, 2001

Description	Debit	Credit
Cash	$ 3,900	
Accounts receivable	4,985	
Inventory	3,300	
Equipment	4,800	
Accumulated depreciation - Equip.		$ 1,440
Furniture and fixtures	6,600	
Accumulated depreciation - furn. & fix.		2,200
Accounts payable		2,985
Notes payable		4,000
Common stock		10,000
Retained earnings, 12/31/00		1,760
Sales Revenues		35,000
COGS	27,500.00	
Operating Expenses	6,300.00	
Totals	$ 57,385	$ 57,385

Note that total debits = total credits

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Sales Revenues		000
COGS		
Operating Expenses		
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Accumulated depreciation is a contra-asset account. It is directly related to an asset account but has the opposite balance.

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Cost - Accumulated depreciation =
BOOK VALUE.

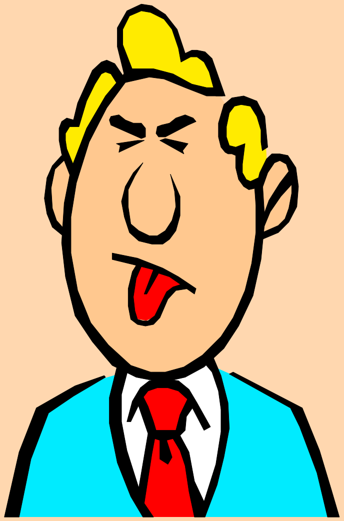
The Unadjusted Trial Balance

If total debits do not equal total credits on the trial balance, errors have occurred . . .

in preparing balanced journal entries.

in posting the correct dollar effects of a transaction.

in copying ending balances from the ledger to the trial balance.



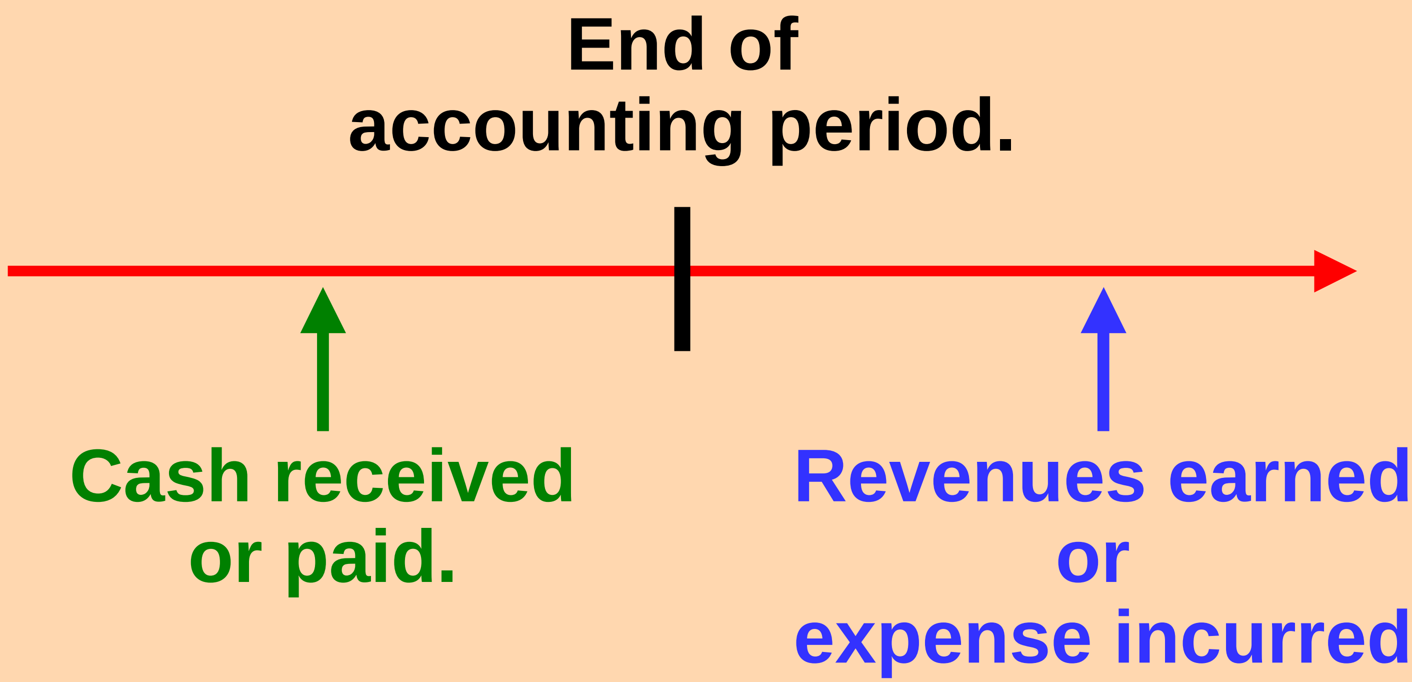

Now that we have covered the trial balance, let’s discuss adjusting entries.
Adjusting Entries

Adjusting Entries

There are two types of adjusting entries.

ACCRUALS	DEFERRALS
Revenues earned or expenses incurred that have not been previously recorded.	Receipts of assets or payments of cash in advance of revenue or expense recognition.

Deferrals



Examples include rent received in advance or insurance paid in advance.

Deferrals - Example 1

On January 1, 2000, Tipton, Inc. paid $3,600 for a 3-year fire insurance policy.

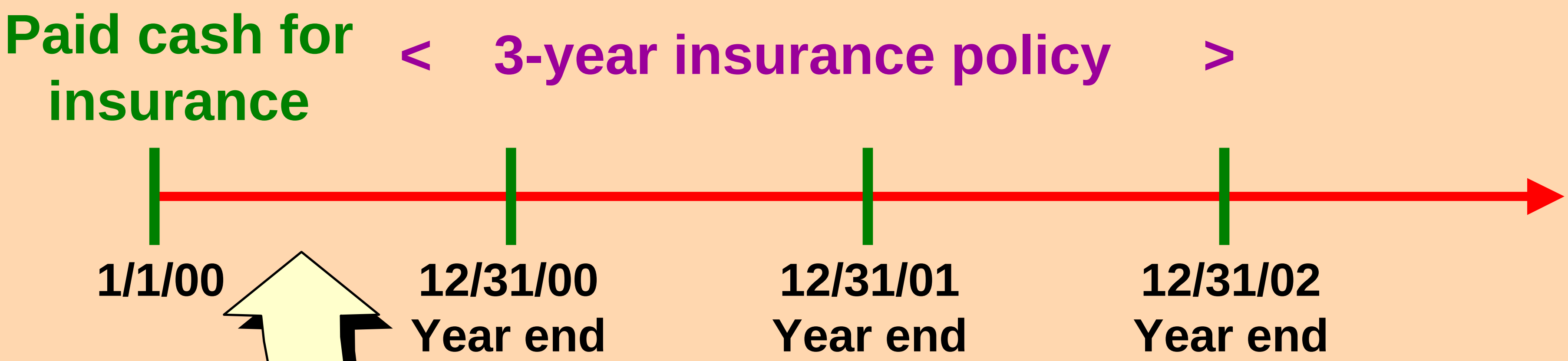
The entry on January 1, 2000, to record the policy on Tipton's books would appear as follows . . .

GENERAL JOURNAL			Page	1
Date		Description	Debit	Credit
Jan.	1	Prepaid Insurance Expense	3,600	
		Cash		3,600

This is an ***ASSET*** account

Irwin/McGraw-Hill

Deferrals - Example 1



Our goal is to record the amount of insurance used up during 2000. Since the policy is for *3 years*, we can assume that 1/3 of the policy will expire each year.

Deferrals - Example 1

On *December 31, 2000*, Tipton must adjust the Prepaid Insurance Expense account to reflect that 1 year of the policy has expired.

$3,600 × 1/3 = $1,200 per year.

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Date		Description	Debit	Credit
Dec	31	Insurance Expense	1,200	
		Prepaid Insurance Exp.		1,200

Deferrals - Example 1

After we post the entry to the T-accounts, the account balances look like this:

Prepaid Insurance Expense

1/1	3,600	12/31	1,200
Bal.	2,400		

Insurance Expense

12/31	1,200		
Bal.	1,200		

Deferrals

Deferrals - Example 2

On December 1, 2001, Tom's Rentals received a check for $3,000, for the first four months' rent of a new tenant.

The entry on December 1, 2001, to record the receipt of the prepaid rent payment would be . . .

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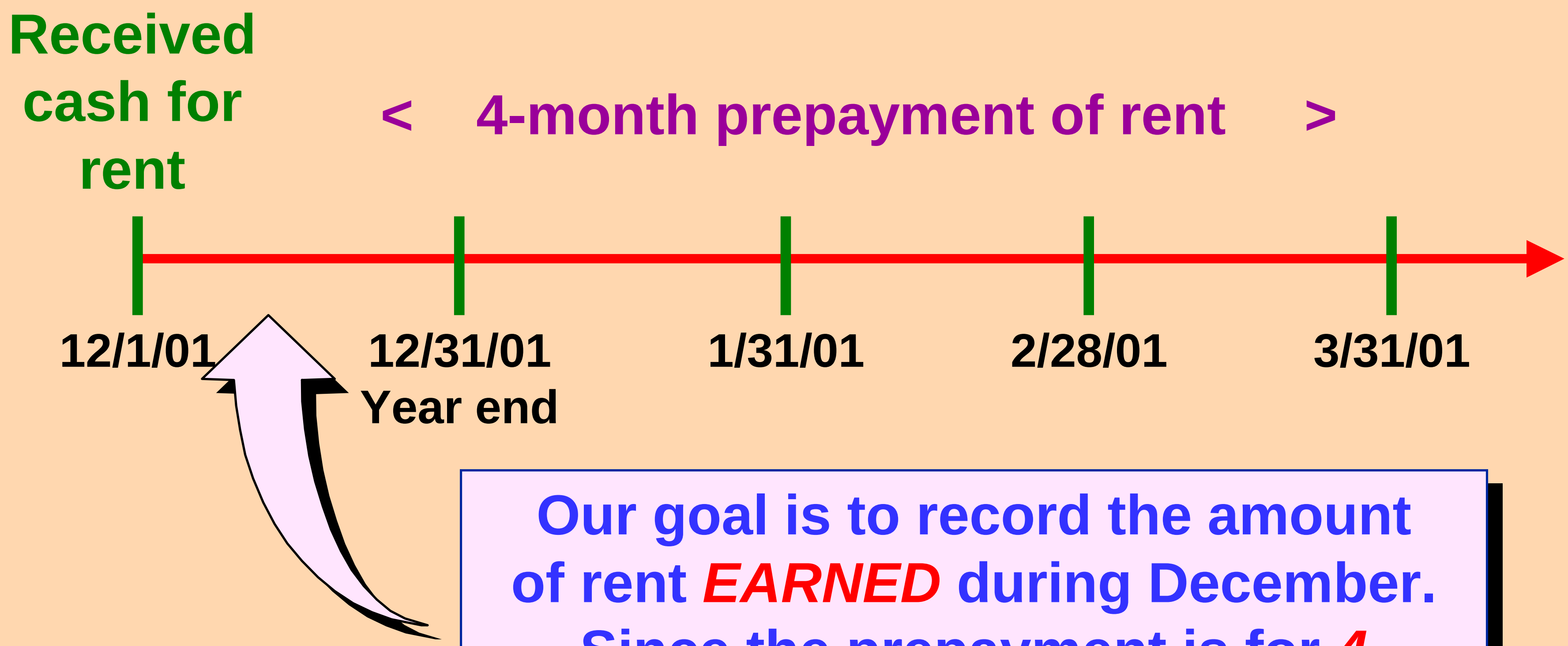
Date		Description	Debit	Credit
Dec	1	Cash	3,000	
		Unearned Rent Revenue		3,000

This is a *LIABILITY* account

Deferrals - Example 2



Our goal is to record the amount of rent *EARNED* during December. Since the prepayment is for *4 months*, we can assume that 1/4 of the rent will be earned each month.

Deferrals - Example 2

On *December 31, 2001*, Tom's Rentals must adjust the Unearned Rent Revenue account to reflect that 1 month of rent revenue has been earned.

$3,000 × 1/4 = $750 per month.

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Date		Description	Debit	Credit
Dec	31	Unearned Rent Revenue	750	
		Rent Revenue		750

Deferrals - Example 2

After we post the entry to the T-accounts, the account balances look like this:

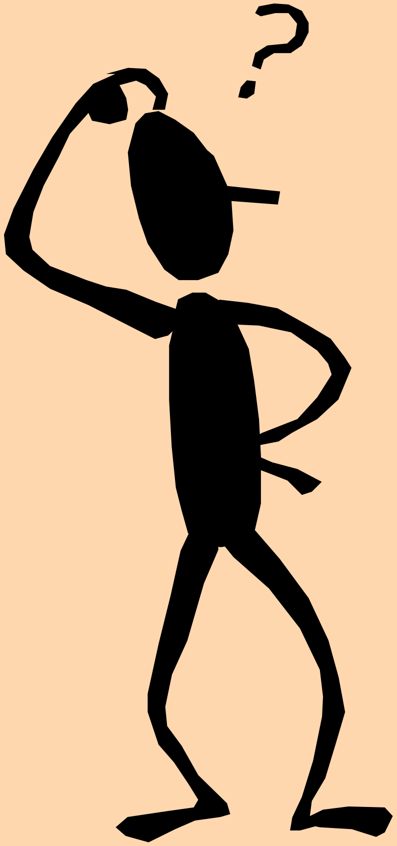
Unearned Rent Revenue

12/31 750	12/1 3000
	Bal. 2,250

Rent Revenue

	12/31 750
	Bal. 750

Accruals



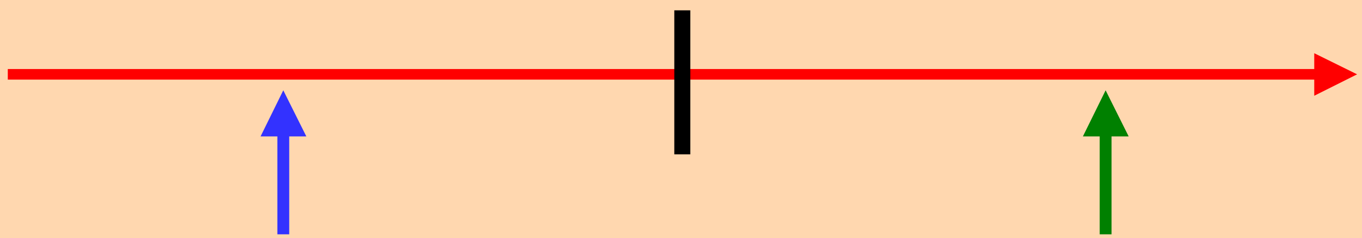
Now, we need to look at adjusting entries for accruals.

Accruals

Accruals occur when revenues have been earned or expenses incurred but no cash has been exchanged.

Accruals

End of accounting period.



Revenues earned or expense incurred

Cash received or paid.

Examples include interest earned during the period or wages earned by employees but not yet paid.

Accruals - Example 1

On October 1, 2001, Webb, Inc. invests $10,000 for 6 months in a certificate of deposit that pays 6% interest *per year*. Webb will not receive the interest until the CD matures on March 31. On December 31, 2001, Webb, Inc. must make an entry for the interest earned so far.

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Date		**Description**	**Debit**	**Credit**
Dec	31	Interest Receivable	150	
		Interest Revenue		150
		$10,000 × 6% × 3/12 = $150		

Accruals - Example 1

After we post the entry to the T-accounts, the account balances look like this:

Interest Receivable

Debit	Credit
12/31 150	
Bal. 150	

Interest Revenue

Debit	Credit
	12/31 150
	Bal. 150

Accruals - Example 2

As of 12/27/02, Denton, Inc. had already paid $1,900,000 in wages for the year. Denton pays its employees every Friday. Year-end, 12/31/02, falls on a Wednesday. The employees have earned total wages of $50,000 for Monday through Wednesday of the week ended 1/02/03.

GENERAL JOURNAL			Page	422
Date		Description	Debit	Credit
Dec	31	Wages Expense	50,000	
		Wages Payable		50,000

Accruals - Example 2

After we post the entry to the T-accounts, the account balances look like this:

Wages Expense

	Debit	Credit
As of 12/27	$1,900,000	
12/31	50,000	
Bal.	$1,950,000	

Wages Payable

Debit		Credit
	12/31	50,000
	Bal.	50,000

Accounting Estimates

- **Certain circumstances require adjusting entries to record accounting estimates.**
- **Examples include . . .**
  - **Depreciation**
  - **Bad debts**
  - **Income taxes**

Accounting Estimates

- **Certain circumstances require adjusting entries to record accounting estimates.**
- **Examples include . . .**
  - **Depreciation**
  - **Bad debts**
  - **Income taxes**

Let's look at how we handle Depreciation expense.

Depreciation

The accounting concept of *depreciation* involves the *systematic* and *rational* allocation of a long-lived asset's cost to the multiple periods it is used to generate revenue.

This is a "cost allocation" concept, not a "valuation" concept.

Depreciation

The required journal entry requires a debit to *Depreciation expense* and a credit to an account called Accumulated depreciation.

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Date		Description	Debit	Credit
Dec	31	Depreciation Expense	$$$$	
		Accumulated Depreciation		$$$$

As discussed earlier, this is called a Contra-Asset account.

Estimates - Example 1

At January 26, 1999, Papa John's trial balance showed Property & equipment of $223,100 (*all numbers in thousands*) and Accumulated depreciation of $48,200. For the period, Papa John's needs to record an additional $1,670 in depreciation.

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Date		**Description**	**Debit**	**Credit**
Jan	26	Depreciation Expense	1,670	
		Accumulated Depreciation		1,670

Estimates - Example 1

After we post the entry to the T-accounts, the account balances look like this:

Depreciation Expense

1/26	1,670	
Bal.	1,670	

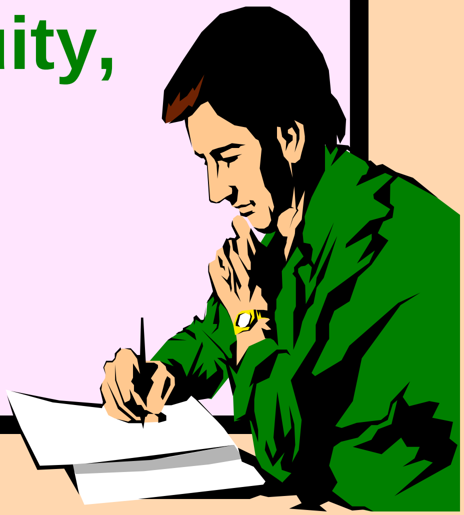
Accumulated Depreciation

	1/26	48,200
	1/26	1,670
	Bal.	49,870

Financial Statement Preparation

The next step in the accounting cycle is to prepare the financial statements. . .

- **Income statement,**
- **Statement of stockholders' equity,**
- **Balance sheet, and**
- **Statement of cash flows.**



Financial Statement Relationships

Net income increases retained earnings, while a net loss will decrease retained earnings. Dividends decreases retained earnings.

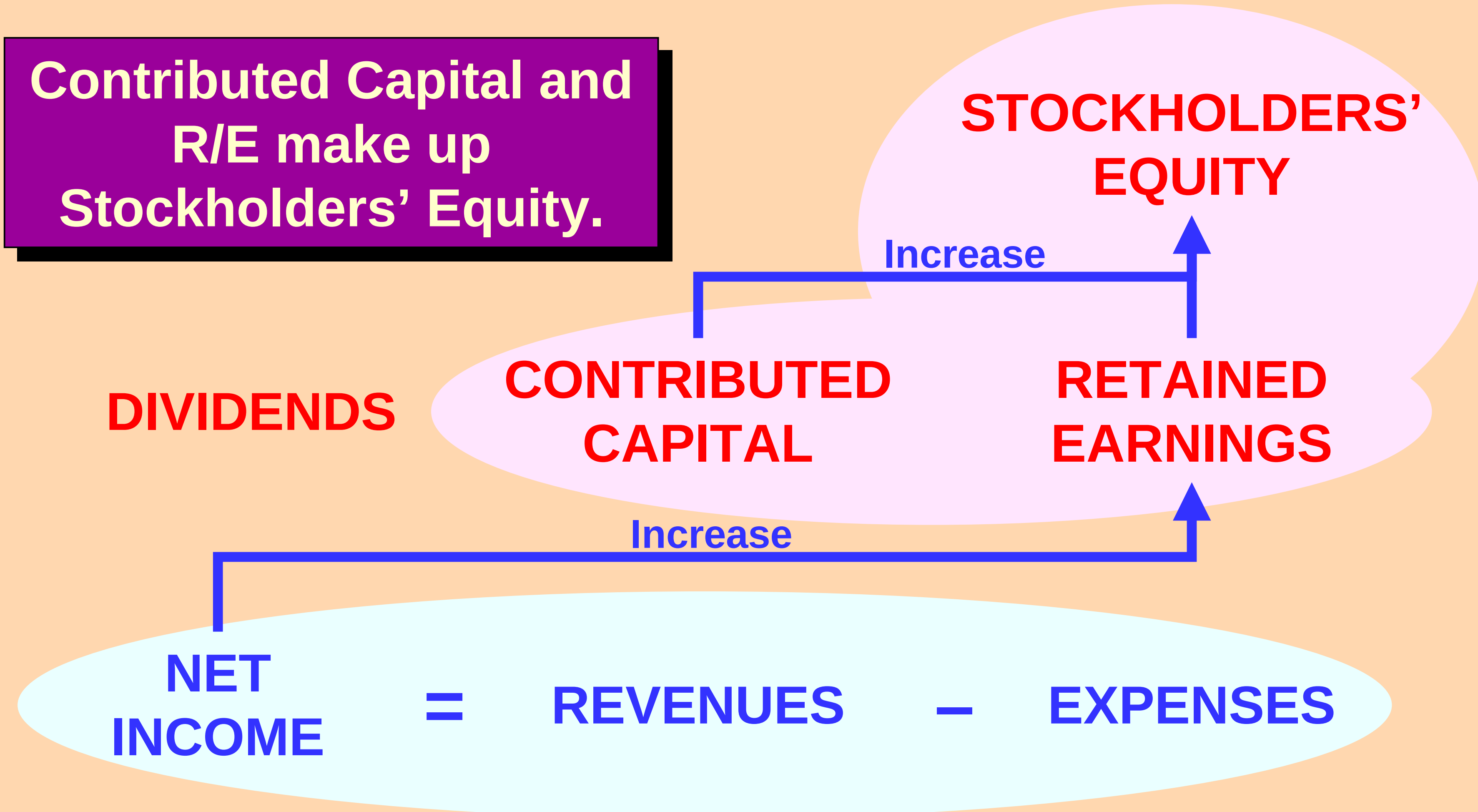
DIVIDENDS —Decrease→ **RETAINED EARNINGS**

NET INCOME —Increase→ **RETAINED EARNINGS**

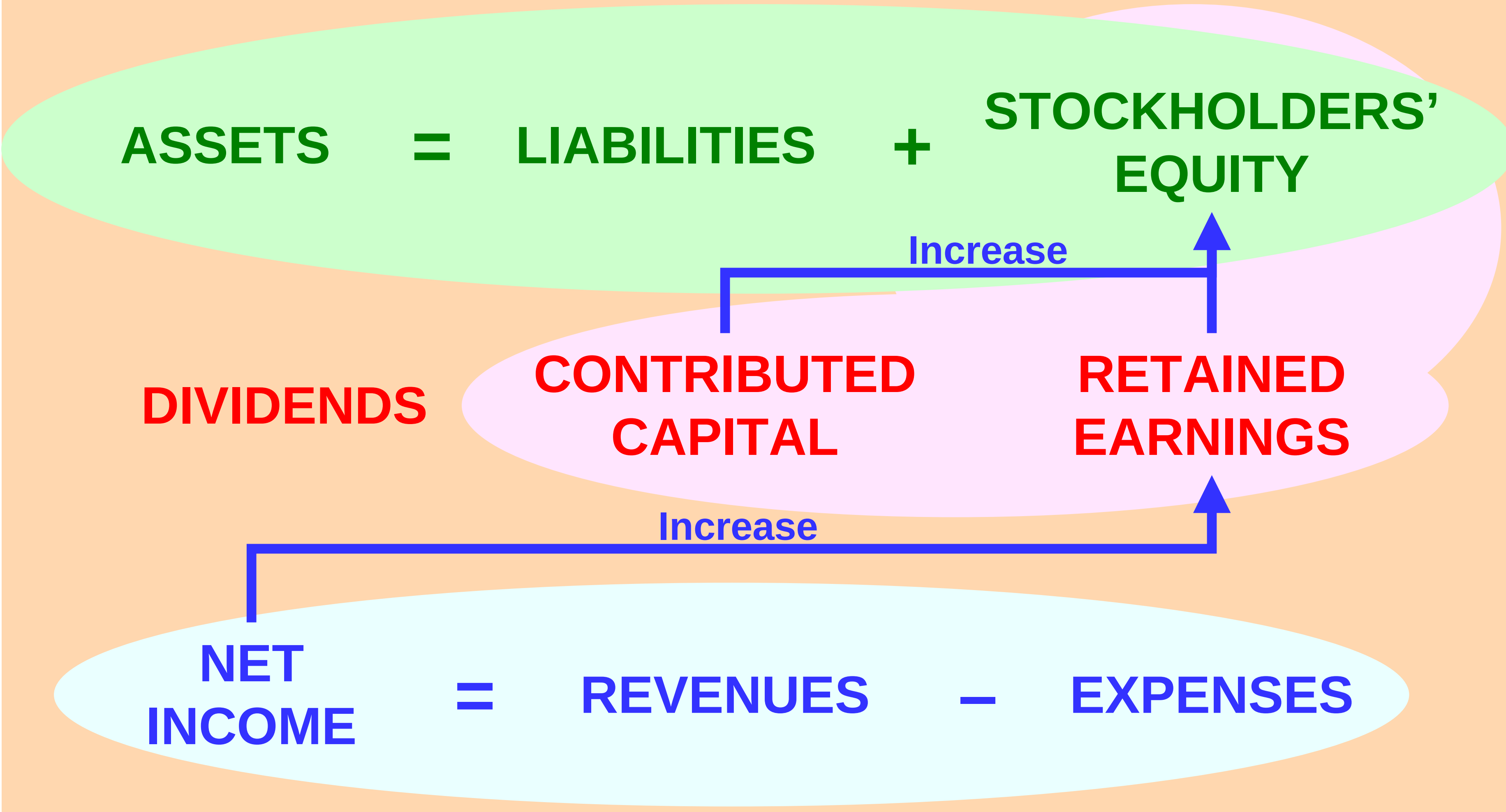
NET INCOME = REVENUES – EXPENSES

Financial Statement Relationships

Contributed Capital and R/E make up Stockholders' Equity.



Financial Statement Relationships



Papa John's International, Inc. and Subsidiaries
Consolidated Statement of Income
Month Ended January 26, 1999
(in thousands of dollars)

Revenues:		
Restaurant sales	$	35,200
Franchise royalties & development fees		3,875
Commissary, equipment, & other sales		34,500
Investment income		455
Total revenues		74,030
Costs and expenses:		
Restaurant expenses:		
Cost of sales		9,600
Salaries & benefits		9,200
Advertising & reltaed costs		2,700
Occupancy costs & other expenses		6,300
		27,800
Commissary, equipment & other expenses:		
Cost of sales		18,900
Salaries, benefits, & other expenses		4,000
		22,900
General & administrative expenses		6,910
Depreciation & amortization		1,670
Other costs & expenses		10
Total cost & expenses		59,290
Income before income taxes		14,740
Income tax expense		5,450
Net income	$	9,290
Earnings per share	$	0.316

Note that this statement has ONLY revenues & expenses!

Earnings Per Share (EPS) must be reported on the income statement.

Income Statement

EPS for Papa John's is based on 29,409,000 shares outstanding and net income of $9,290,000.

EPS	**=**	**Net Income**	**÷**	**Weighted-Average # of common shares outstanding for the period.**
	=	**$ 9,290,000**	**÷**	**29,409,000**
	=	**$ 0.316**	**per share**	

Statement of Stockholders' Equity

Net income appears on the statement of stockholders' equity as an increase in Retained Earnings.

Papa John's International, Inc. and Subsidiaries
Consolidated Statement of Stockholders' Equity
For the Month Ended January 26, 1999
(in thousands of dollars)

	Contributed Capital	Retained Earnings	Stockholders' Equity
Beginning balance, 12/27/98	$ 164,500	$ 98,200	$ 262,700
Stock Issuance	1,300		1,300
Net income		9,290	9,290
Dividends		(200)	(200)
Ending balance, 1/26/99	**$ 165,800**	**$ 107,290**	**$ 273,090**

Balance Sheet

Papa John's International, Inc. & Subsidiaries
Consolidated Balance Sheet
January 26, 1999
(in thousands of dollars)

Assets		
Current Assets:		
Cash	$	55,415
Accounts receivable		15,450
Inventories		10,200
Prepaid expenses		7,500
Other current assets		2,430
Total current assets		90,995
Investments		50,300
Net property and equipment		173,230
Notes receivable		16,750
Other assets		22,400
Total assets	$	353,675

$223,100 cost - 49,870 accumulated depreciation and amortization.

Balance Sheet - Continued

Papa John's International, Inc. & Subsidiaries
Consolidated Balance Sheet
January 26, 1999
(in thousands of dollars)

Liabilities & stockholders' equity		
Current liabilities:		
Accounts payable	$	28,100
Accrued expenses payable		29,100
Income taxes payable		5,450
Other current liabilities		10
Total current liabilities		62,660
Unearned franchise & development fees		6,725
Other long-term liabilities		11,200
Stockholders' equity:		
Contributed capital		165,800
Retained earnings		107,290
Total stockholders' equity		273,090
Total liabilities & stockholders' equity	$	353,675

Remember that Total liabilities and stockholders' equity ($353,675) must equal Total assets ($353,675).

The Closing Process

Even though the balance sheet account balances carry forward from period to period, the income statement accounts do not.

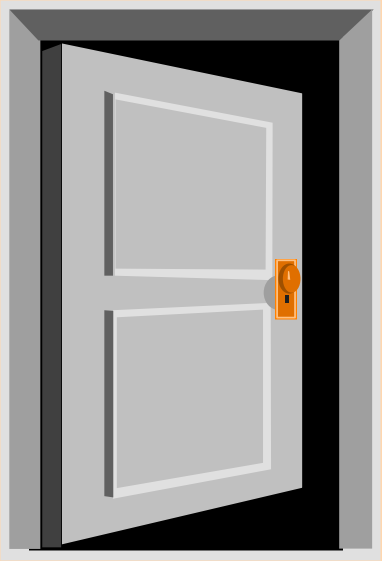
Closing entries:

- ☆ **Transfer net income (or loss) to Retained Earnings.**
- **Establish a zero balance in each of the *temporary* accounts to start the next accounting period.**

The Closing Process

The following accounts are called temporary or nominal accounts and are closed at the end of the period . . .

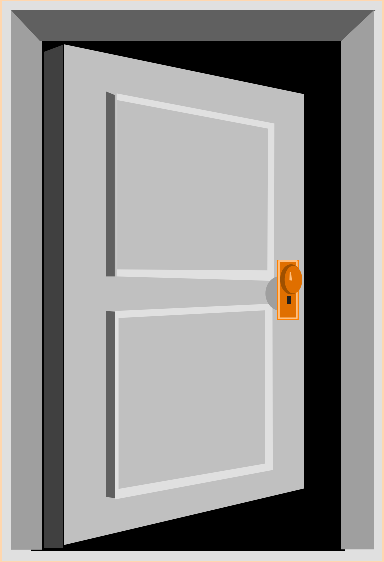
- **Revenues**
- **Expenses**
- **Gains,**
- **Losses, and**
- **Dividends declared.**



The Closing Process

Assets, liabilities, and stockholders' equity are permanent, or real accounts, and are never closed.

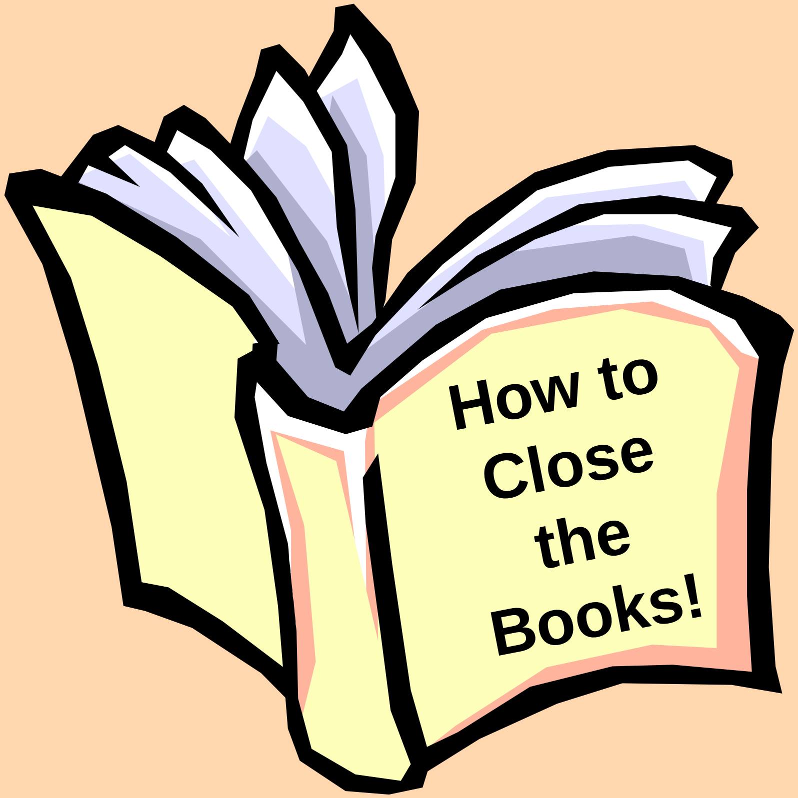
- **Assets**
- **Liabilities**
- **Stockholders' Equity**



The Closing Process

Two steps are used in the closing process . . .

- **Close revenues and gains to Retained Earnings.**
- **Close expenses and losses to Retained Earnings.**



The Closing Process

To close Papa John's *Restaurant Sales Revenue* account, the following entry is required:

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Date		Description	Debit	Credit
Jan	26	Restaurant Sales Revenue	35,200	
		Retained Earnings		35,200

Retained Earnings

	98,200	Beg. Bal.
	35,200	Close

Restaurant Sales Revenue

35,200	35,200

The Closing Process

If we close the other revenue accounts in a similar fashion, the retained earnings account looks like this . . .

Retained Earnings		
	98,200	Beg. Bal.
	35,200	Close
	3,875	Close
	34,500	Close
	455	Close

The Closing Process

To close Papa John's *Cost of Sales - Restaurants* account, the following entry is required:

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Date		Description	Debit	Credit
Jan	26	Retained Earnings	9,600	
		Cost of Sales - Restaurants		9,600

Retained Earnings

9,600	

Cost of Sales Restaurants

9,600	9,600	Close

The Closing Process

If we close the other expense accounts in a similar fashion, the retained earnings account looks like this . . .

Retained Earnings

Close	9,600	98,200	Beg. Bal.
Close	9,200	35,200	Close
Close	2,700	3,875	Close
Close	6,300	34,500	Close
Close	18,900	455	Close
Close	2,500		
Close	1,500		
Close	6,910		
Close	1,670		
Close	10		
Close	5,450		

The Closing Process

Finally, we close dividends to Retained Earnings and the account balances out to $107,290 and looks like this . . .

Retained Earnings

Close	9,600	98,200	Beg. Bal.
Close	9,200	35,200	Close
Close	2,700	3,875	Close
Close	6,300	34,500	Close
Close	18,900	455	Close
Close	2,500		
Close	1,500		
Close	6,910		
Close	1,670		
Close	10		
Close	5,450		
Close	200		
		107,290	End Bal.

End of Chapter 4