Thammasat University
Faculty of Economics
Bachelor of Economics (International Program)

AC 201

Fundamental Accounting

Semester 1/2016

Course Materials

Topics:
Chapter 4 Adjustments, Financial Statements, and the Quality of Earnings

Session:
Sessions #4 and #5

Instructor:
Ajarn Santana Singhasaneh

Introduction to Financial Statements

FINANCIAL STATEMENTS	ASSETS	LIABILITIES	EQUITY

✓ • Statement of Financial Position
✓ • Statement of Comprehensive Income
✓ • Statement of Changes in Equity
✓ • Statement of Cash Flows
	• Cash
	• Investments in debt and equity securities
	• Accounts receivable
	• Notes receivable
	• Inventory
	• Prepaid expenses
	• Property, plant, and equipment
	• Intangible assets
	• Natural resources
		• Accounts payable
		• Accrued liabilities
		• Unearned revenues
		• Notes payable
		• Bonds payable
			• Common Stock
			  • Preferred share
			  • Ordinary share
			• Retained earnings
			  • Appropriated R/E
			  • Unappropriated R/E
			• Treasury share

Accounting Cycle

Financial Statement Items

We are here

Adjustments, Financial Statement Preparation, and Closing Process

FINANCIAL STATEMENT ANALYSIS

AC201 Fundamental Accounting

CHAPTER 4: ADJUSTMENTS, FINANCIAL STATEMENTS, AND THE QUALITY OF EARNINGS

Ajarn Santana Singhasaneh
Department of Accounting
Thammasat Business School
Thammasat University

The Accounting Cycle

Preparing a Trial Balance

The Trial Balance

Before using the account balances from the general ledger to prepare a statement of financial position and a statement of income, it is desirable to **"prove"** that the total of accounts with debit balances is equal to the total of accounts with credit balances.
This proof of equality of debit and credit balances is called a **TRIAL BALANCE**.

A **trial balance** is an internal document used to summarize all of the account balances in a company's accounting system.

- A trial balance is a 2-column schedule listing the names and balances of all the accounts in the financial statement order, with their debit and credit balances
- Ending debit or credit balances are listed in two separate columns, debit balances in the left-hand column and the credit balances in the right hand column.
- Total debit account balances should equal total credit account balances.

Unadjusted Trial Balance

Balance taken from each ledger account

This is retained earnings at Jan 1, 2009, an accumulation of earnings from previous periods

PAPA JOHN'S INTERNATIONAL, INC.
Trial Balance
At January 31, 2009
(dollars in thousands)

	Unadjusted Trial Balance		
	Debit	Credit	
Cash	41,900		Assets (A)
Accounts receivable	20,200		
Interest receivable	0		
Supplies	16,000		
Prepaid expenses	19,000		
Other current assets	13,000		
Investments (long-term)	2,000		
Property and equipment	388,000		
Accumulated depreciation		189,000	
Notes receivable (long-term)	11,000		
Intangibles	77,000		
Other assets	36,000		
Accounts payable		39,000	Liabilities (L)
Dividends payable		3,000	
Accrued expenses payable		71,000	
Income tax payable		0	
Unearned franchise fees		6,300	
Notes payable (long-term)		138,000	
Other long-term liabilities		27,000	
Common stock		9,000	Stockholders' Equity (E)
Retained earnings		120,000	

May need an accrual for any amount earned from franchisees but not yet recorded
May need an accrual for any investment income earned but not yet recorded
May need an adjustment for the amount of supplies used during the period
May need an adjustment for the amount of rent and insurance used during period

Represents the historical cost of property and equipment → Property and equipment
Represents the total amount of the cost of property and equipment used in the past → Accumulated depreciation

For reporting purposes:

Property and Equipment	(cost)	$388,000
− Accumulated Depreciation	(used cost)	189,000
Net book value	(unused cost)	$199,000

May need an accrual for any wages, utilities, and interest incurred
Needs an accrual for the amount of income tax expense incurred during period
May need an adjustment for the amount earned during period

Represents the beginning balance of retained earnings minus dividends declared during the month ($123,000 − $3,000) → Retained earnings

Unadjusted Trial Balance

Revenue from selling pizza and ingredients plus equipment to franchisees	Restaurant sales revenue		66,000	REV
Revenue from selling franchises during the period	Franchise fee revenue		2,800	*Revenues and Gains*
Revenue on investments earned during the period	Investment income		1,000	
	Gain on sale of land		3,000	72,800
	Cost of sales	30,000		
Expense for wages incurred during the period	Salaries expense	14,000		
Summary for many operating expenses	General and administrative expenses	7,000		51,000
Expense for supplies used during period	Supplies expense	0		*Expenses and Losses*
Expense for rent used during period	Rent expense	0		EXP
Expense for insurance used during period	Insurance expense	0		
Expense for utilities used during period	Utilities expense	0		
Expense for property and equipment used during period	Depreciation expense	0		
Expense for interest incurred on debt during period	Interest expense	0		
Expense for income taxes incurred during period	Income tax expense	0		
Debits = Credits →	Total	$675,100	$675,100	

By adding all the debit balances and all the credit balances,
we can see whether total debits equal total credits.
Thus, **the accounting equation is in balance.**

Adjusting Revenue & Expenses

Purpose of Adjustments

Accrual Accounting

A better measure of performance than cash-basis accounting.

Revenues are recorded when earned.

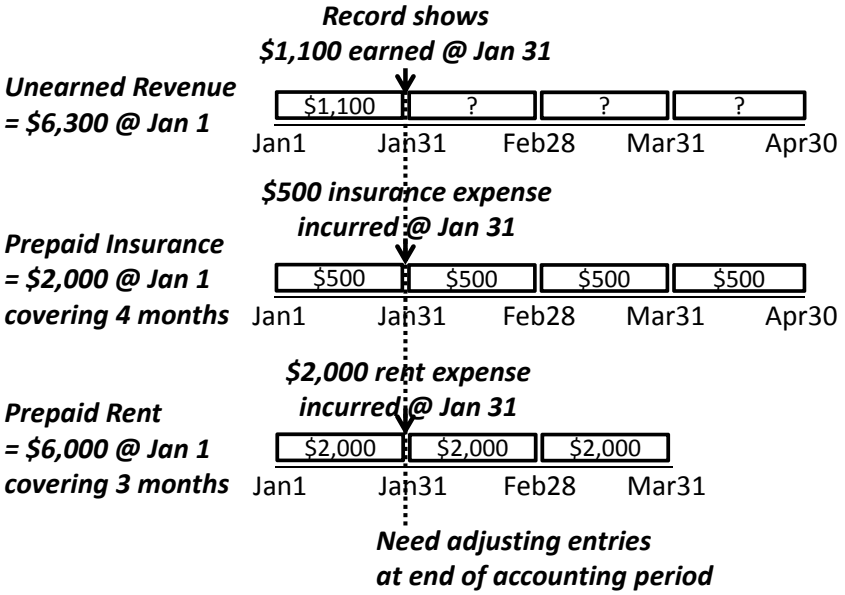
Expenses are recorded when incurred.

Matching Principle

All costs and expenses incurred in generating revenues must be recognized in the same reporting period as the related revenues.

Purpose of Adjustments

Certain transactions affect the revenue or expenses of 2 or more accounting periods. The purpose of adjusting entries is ***to assign appropriate amounts of revenue and expense to each accounting period***.



Adjusting Entries

- ***ADJUSTING ENTRIES*** are the journal entries that bring the accounts up to date at the end of the accounting period.
- Each adjusting entry always involves at least one statement of income account and one statement of financial position account.
- Adjusting entries never involve cash

Because transactions occur over time,
ADJUSTING ENTRIES are required **at the end of each accounting period** to get the revenues and expenses into the "right" period.

Most adjusting entries fall into one of four categories:

Adjusting entries that increase REVENUES

1. Converting liabilities to revenue.
2. Accruing uncollected revenue.

Adjusting entries that increase EXPENSES

3. Converting assets to expenses.
4. Accruing unpaid expenses.

Types of Adjusting Entries

Adjusting Entries that Increase Revenues:

- **Deferred Revenues** – Previously recorded liabilities that were created when cash was received in advance, and that must be reduced for the amount of revenue actually earned during the period.

Unearned Revenue

- **Accrued Revenues** – Revenues that have been earned but not yet recorded because cash will be received after the services are performed or goods are delivered.

Accounts Receivable, Interest Receivable

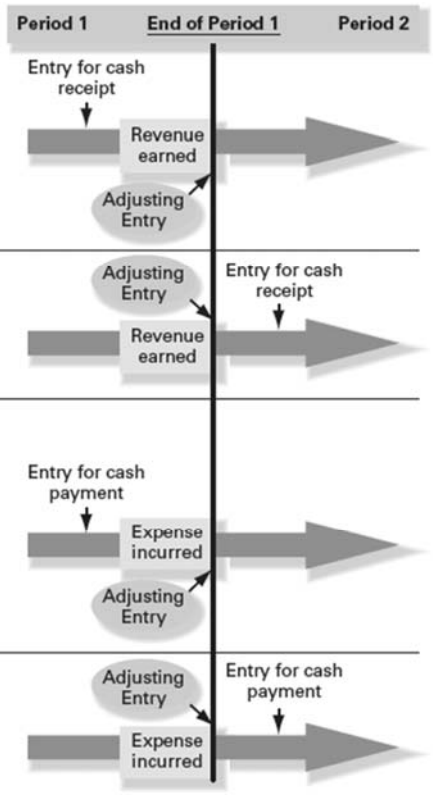
Adjusting Entries that Increase Expenses:

- **Deferred Expenses** – Previously recorded assets, such as Prepaid Rent, Supplies, and Equipment, that were created when cash was paid in advance and that must be reduced for the amount of expense actually incurred during the period through use of the asset.

Prepaid Expenses, Supplies, Accum. Depreciation

- **Accrued Expenses** – Expenses that have been incurred but not yet recorded because cash will be paid after the goods or services are used.

Accrued Expenses, Income Tax Payable



Adjusting Entries – Increase Revenues (1)

I. Converting liability to revenue

If cash was received and previously recorded:

Journal entry at the time cash was received

Cash (A+)	90	
Unearned revenue (L+)		90

At the end of accounting period,
revenue has been earned, the **ADJUSTING ENTRY** is:

Adjusting entry at end of period

Unearned revenue (L-)	**30**	
Revenue (REV+, SE+)		**30**

← **Revenue increases**

Adjusting Entries – Increase Revenues (2)

II. Accruing uncollected revenue

If cash has NEVER been received:

----- No transaction -----

At the end of accounting period,
revenue has been earned, cash will be received in the future,
the **ADJUSTING ENTRY** is:

Adjusting entry at end of period

Accounts receivable (A+)	**30**	
Revenue (REV+, SE+)		**30**

← **Revenue increases**

Adjusting Entries – Increase Expenses (1)

III. Converting assets to expenses

Journal entry at the time cash was paid

If cash was paid and previously recorded:

Prepaid expense (A+)	80	
Cash (A-)		80

At the end of accounting period,
expense has been incurred, the **ADJUSTING ENTRY** is:

Adjusting entry at end of period

Expense (EXP+, SE-)	**20**	
Prepaid expense (A-)		**20**

Expense increases

Adjusting Entries – Increase Expenses (2)

IV. Accruing unpaid expenses

If cash has NEVER been paid:

----- No transaction -----

At the end of accounting period,
expense has been incurred, cash will be paid in the future,
the **ADJUSTING ENTRY** is:

Adjusting entry at end of period

Expense (EXP+, SE-)	**20**	
Accrued expense (L+)		**20**
(or Accounts payable)		

Expense increases

Adjusting Entries: An Illustration

Unearned Revenue

Last period, Papa John's received cash and recorded an increase in Cash and increase in Unearned Franchise Fees, a liability, to recognize the business's obligation to provide future services to franchisees. **During January 2009**, Papa John's performed $1,100 in services for franchisees who had previously paid fees.

I. Converting liability to revenue

This adjusting entry is made on Jan 31, 2009

Step 2

AJE 1:	Debit	Credit
Unearned Franchise Fees (–L)	1,100	
Franchise Fee Revenue (+R, +SE)		1,100

Step 1 Step 3

Assets	=	Liabilities	+	Stockholders' Equity	
		–1,100		+1,100	Franchise Fee Revenue (+R)

Accounts Receivable

Papa John's franchisees owe Papa John's $830 in royalties for sales the franchisees made in the last week of January. The cash will be received in the future.

This adjusting entry is made on Jan 31, 2009

II. Accruing uncollected revenue

Step 2

AJE 2:	Debit	Credit
Accounts Receivable (+A)	830	
Franchise Fee Revenue (+R, +SE)		830

Step 1 Step 3

Assets	=	Liabilities	+	Stockholders' Equity	
+830				+830	Franchise Fee Revenue (+R)

Interest Receivable (1)

Papa John's loaned $3,000 to franchisees on December 31 (one month ago) at 6 % interest per year with interest to be paid at the end of each year.
There are two components when lending or borrowing money: ***principal*** (the amount loaned or borrowed) and ***interest*** (the cost of borrowing).
There was also $8,000 in notes receivable outstanding all month from prior loans.
Notes Receivable (the principals) were recorded properly when the money was loaned.

Principal	×	Rate per Year	×	Number of Months (since last computation)/12	=	Interest for the Period
$3,000	×	.06	×	1 month /12 months	=	$15
Assume interest on the other $8,000 in notes receivable					=	55
Total interest earned						$70

Add this $70 amount to the adjusting journal entry.

Interest Receivable (2)

II. Accruing uncollected revenue

This adjusting entry is made on Jan 31, 2009

Step 2

AJE 3:	Debit	Credit
Interest Receivable (+A)	70	
Investment Income (+R, +SE)		70

Step 1 Step 3

Assets	=	Liabilities	+	Stockholders' Equity	
+70				+70	Investment Income (+R)

Prepaid Expense (1)

Prepaid Expenses includes:

- $2,000 paid on January 1 for insurance coverage for 4 months, and
- $6,000 paid on January 1 for rental of space over 3 months

Compute the amount of expense incurred.

One month has expired for each of the prepaid amounts:

- Insurance: $2,000 x 1 month/4 months = $ 500 used in January.
- Rent: $6,000 x 1 month/3 months = $ 2,000 used in January.

$500 insurance expense incurred @ Jan 31

Insurance = $2,000 @ Jan 1 covering 4 months

$500	$500	$500	$500

Jan1 Jan31 Feb28 Mar31 Apr30

$2,000 rent expense incurred @ Jan 31

Rent = $6,000 @ Jan 1 covering 3 months

$2,000	$2,000	$2,000

Jan1 Jan31 Feb28 Mar31

Need adjusting entriesat end of accounting period [See Slide #24]

Prepaid Expense (2)

III. Converting assets to expenses

This adjusting entry is made on Jan 31, 2009

Step 1

AJE 4:	Debit	Credit
Insurance Expense (+E, –SE)	500	
Rent Expense (+E, –SE)	2,000	
Prepaid Expenses (–A)		2,500

Step 2 Step 3

Assets	=	Liabilities	+	Stockholders' Equity	
–2,500				–500	Insurance Expense (+E)
				–2,000	Rent Expense (+E)

Prepaid Expense (3)

Followings are **adjusting journal entries** at the end of each month:

III. Converting assets to expenses

Date	Account Title & Explanation	Debit	Credit
Jan 31	Insurance expense (EXP+, SE-)	500	
	Rent expense (EXP+, SE-)	2,000	
	Prepaid expenses (A-)		2,500
Feb 28	Insurance expense (EXP+, SE-)	500	
	Rent expense (EXP+, SE-)	2,000	
	Prepaid expenses (A-)		2,500
Mar 31	Insurance expense (EXP+, SE-)	500	
	Rent expense (EXP+, SE-)	2,000	
	Prepaid expenses (A-)		2,500
Apr 30	Insurance expense (EXP+, SE-)	500	
	Prepaid expenses (A-)		500

Supplies (1)

Supplies include food and paper products.
At the end of the month, Papa John's counted $12,000 in supplies on hand,
but the Supplies account indicated a balance of $16,000.
We need to determine the ***supplies used*** during the current accounting period.

count at beginning of month + **0** Purchased during the month - **?** Used during the month = **count** at end of month

This needs to be adjusted as Supplies Expense

Computation of Supplies Expense:

Beginning balance of supplies	$ 16,000 unadjusted balance
+ Supply purchases during period	
– Ending amount of supplies on hand	–12,000
= Supplies used during the period	$ 4,000

Supplies (2)

III. Converting assets to expenses

This adjusting entry is made on Jan 31, 2009

Step 1

AJE 5:	Debit	Credit
Supplies Expense (+E, –SE)	4,000	
Supplies (–A)		4,000

Step 2 Step 3

Assets	=	Liabilities	+	Stockholders' Equity	
–4,000				–4,000	Supplies Expense (+E)

Property and Equipment (1)

Property and equipment include building and all types of equipment, fixtures, furnishings. They are ***physical objects*** that retain their size and shape but that eventually wear out or become obsolete. They are ***NOT physically consumed***, as are supplies, but nonetheless their economic usefulness diminished over time.

Each period, a portion of these assets' usefulness expires. Therefore, a corresponding portion of their costs are recognized as ***"depreciation expense."***

Property and equipment are assets that have a normal debit balance. **Depreciation is the systematic allocation of the cost of an asset to expense over the asset's estimated useful life.** Depreciation is an expense with a normal debit balance.

Property and Equipment (2)

When we record depreciation we credit a "contra asset account" called "***Accumulated Depreciation***." Contra-accounts are accounts that are directly linked to another account, but with an opposite balance. Therefore, accumulated depreciation has a normal credit balance. We subtract accumulated depreciation from the cost of our property and equipment to arrive at net book value.

	Year 1	Year 2	Year 5
Building	$35,000	$35,000	$35,000
Less: Accumulated depreciation	(7,000)	(14,000)	(35,000)
Building - net	$28,000	$21,000	$ 0

asset account **A** **contra-asset account** **XA**

+ Property and Equipment (A) –	
Beginning bal. Buy	Sell
Ending bal.	

–

– Accumulated Depreciation (XA) +	
	Beginning bal. Used
	Ending bal.

Property and Equipment (3)

Papa John's estimates depreciation to be $30,000 per year.
$30,000 ÷ 12 months = $2,500 per month depreciation expense

Cost of asset = $30,000 @ Jan 1

$2,500	$2,500	$2,500	- - - - - - -	$2,500	$2,500	$2,500
Jan1	Jan31	Feb28	Mar31	Sep30	Oct31	Nov30	Dec31

Need an adjusting entry at end of accounting period

III. Converting assets to expenses

This adjusting entry is made on Jan 31, 2009

Step 1

AJE 6:	Debit	Credit
Depreciation Expense (+E, –SE)	2,500	
Accumulated Depreciation (+XA, –A)		2,500

Step 2 Step 3

Assets	=	Liabilities	+	Stockholders' Equity	
–2,500				–2,500	Depreciation Expense (+E)

Accrued Expenses /Accounts Payable (1)

Papa John's owed:

(1) its employees salaries for working four days at the end of January at $500 per day

Accrued salaries expense = $500 per day × 4 days
= **$2,000**

(2) $610 for utilities used in January

Accrued utilities expense = **$610**

(3) interest on its $138,000 long-term notes payable borrowed at a 6 percent annual rate.

Accrued interest expense = $138,000 × 0.06 × 1/12
= **$690**

Total Accrued expenses = **$3,300**

Accrued Expenses /Accounts Payable (2)

IV. Accruing unpaid expenses

This adjusting entry is made on Jan 31, 2009

Step 1

AJE 7:	Debit	Credit
Salaries Expense (+E, –SE)	2,000	
Utilities Expense (+E, –SE)	610	
Interest Expense (+E, –SE)	690	
Accrued Expenses Payable (+L)		3,300

Step 2 Step 3

Assets	=	Liabilities	+	Stockholders' Equity	
		+3,300		–2,000	Salaries Expense (+E)
				–610	Utilities Expense (+E)
				–690	Interest Expense (+E)

Income Tax Payable (1)

The final adjusting journal entry is to record the accrual of ***income taxes*** that will be paid in the next quarter. This requires computing adjusted pretax income (that is, balances from the unadjusted trial balance plus the effects of all of the other adjustments):

	Revenues and Gains		Expenses and Losses		
Unadjusted totals	$72,800		$51,000		
AJE 1	1,100				
AJE 2	830				
AJE 3	70				
AJE 4			2,500		
AJE 5			4,000		
AJE 6			2,500		
AJE 7			3,300		
	$74,800	–	$63,300	=	$11,500 Pretax income

From our unadjusted trial balance shown earlier

From all the adjusting journal entries in slides #18-30

Income Tax Payable (2)

Papa John's average income tax rate is 34 percent.
So, the estimated amount of the taxes on this income
that will be at the end of the quarter is $11,500 × 0.34 = $3,910.

IV. Accruing unpaid expenses

This adjusting entry is made on Jan 31, 2009

AJE 8:

Step 1

	Debit	Credit
Income Tax Expense (+E, –SE)	3,910	
Income Tax Payable (+L)		3,910

Step 2 Step 3

Assets	=	Liabilities	+	Stockholders' Equity	
		+3,910		–3,910	Income Tax Expense (+E)

Ethics and Adjusting Entries

Adjustments and Incentives

Owners and managers of companies are most directly affected by the information presented in financial statements. If the financial performance and condition of the company appear strong, the company's stock price rises. Shareholders usually receive dividends and increase their investment value. Managers often receive bonuses based on the strength of a company's financial performance, and many in top management are compensated with options to buy their company's stock at prices below market value. The higher the market value, the more compensation they earn. When actual performance lags behind expectations, managers and owners may be tempted to manipulate accruals and deferrals to make up part of the difference. For example, managers may record cash received in advance of being earned as revenue in the current period or may fail to accrue certain expenses at year-end.

Evidence from studies of large samples of companies indicates that some managers do engage in such behavior. This research is borne out by enforcement actions of the Securities and Exchange Commission against U.S. companies and sometimes against their auditors. In January 2003, an SEC study reported that, in a five-year period, there were 227 enforcement investigations. Of these, "126 involved improper revenue recognition and 101 involved improper expense recognition. . . . Of the 227 enforcement matters during the Study period, 157 resulted in charges against at least one senior manager. . . . Furthermore, the Study found that 57 enforcement matters resulted in charges for auditing violations. . . ." (p. 47).*

In many of these cases, the firms involved, their managers, and their auditors are penalized for such actions. Furthermore, owners suffer because news of an SEC investigation negatively affects the company's stock price.

*These statistics are reported in the Securities and Exchange Commission's study, "Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002," January 27, 2003.

Preparing the Financial Statements

Praparing the Financial Statements

Before we prepare a complete set of financial statements, let's ***update the trial balance*** to reflect the adjustments and provide us with adjusted balances for the statements.

1. Statement of Income,
2. Statement of stockholders' equity,
3. Statement of financial position, and
4. Statement of cash flows.

Adjusted Trial Balance

Effects of the adjusting entries

PAPA JOHN'S INTERNATIONAL, INC.
Trial Balance at January 31, 2009
(dollars in thousands)

	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance	
	Debit	Credit	Debit	Credit	Debit	Credit
Cash	41,900				41,900	
Accounts receivable	20,200		AJE 2 830		21,030	
Interest receivable	0		AJE 3 70		70	
Supplies	16,000			AJE 5 4,000	12,000	
Prepaid expenses	19,000			AJE 4 2,500	16,500	
Other current assets	13,000				13,000	
Investments (long-term)	2,000				2,000	
Property and equipment	388,000				388,000	
Accumulated depreciation		189,000		AJE 6 2,500		191,500
Notes receivable (long-term)	11,000				11,000	
Intangibles	77,000				77,000	
Other assets	36,000				36,000	
Accounts payable		39,000				39,000
Dividends payable		3,000				3,000
Accrued expenses payable		71,000		AJE 7 3,300		74,300
Income tax payable		0		AJE 8 3,910		3,910
Unearned franchise fees		6,300	AJE 1 1,100			5,200
Notes payable (long-term)		138,000				138,000
Other long-term liabilities		27,000				27,000
Common stock		9,000				9,000
Retained earnings		120,000				120,000

A

L

E

To prepare Statement of Financial Position

Adjusted Trial Balance

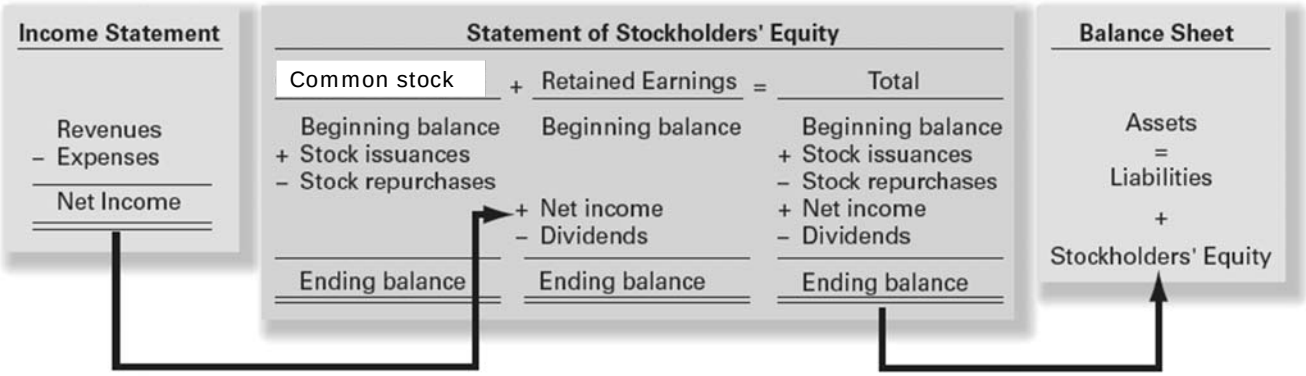
Restaurant sales revenue		66,000				66,000
Franchise fee revenue		2,800		AJE 1 1,100 AJE 2 830		4,730
Investment income		1,000		AJE 3 70		1,070
Gain on sale of land		3,000				3,000
Cost of sales	30,000				30,000	
Salaries expense	14,000		AJE 7 2,000		16,000	
General and administrative expenses	7,000				7,000	
Supplies expense	0		AJE 5 4,000		4,000	
Rent expense	0		AJE 4 2,000		2,000	
Insurance expense	0		AJE 4 500		500	
Utilities expense	0		AJE 7 610		610	
Depreciation expense	0		AJE 6 2,500		2,500	
Interest expense	0		AJE 7 690		690	
Income tax expense	0		AJE 8 3,910		3,910	
Total	$675,100	$675,100	$18,210	$18,210	$685,710	$685,710

REV

EXP

To prepare Statement of Income

Financial Statement Relationships



Statement of Income

This is the statement of income drawn from the ***adjusted trial balance***. Refer back to the adjusted trial balance and trace the statement of income numbers forward. Notice that gains and losses are reported in the "Other Items" section of the statement.

PAPA JOHN'S INTERNATIONAL, INC., AND SUBSIDIARIES
Consolidated Statement of Income
For the Month Ended January 31, 2009
(dollars in thousands)

Operating Revenues	
Restaurant sales revenue	$66,000
Franchise fee revenue	4,730
Total revenues	70,730
Operating Expenses	
Cost of sales	30,000
Salaries expense	16,000
General and administrative expenses	7,000
Supplies expense	4,000
Rent expense	2,000
Insurance expense	500
Utilities expense	610
Depreciation expense	2,500
Total expenses	62,610
Operating Income	8,120
Other Items	
Investment income	1,070
Interest expense	(690)
Gain on sale of land	3,000
Income before Income Taxes	11,500
Income tax expense	3,910
Net Income	$ 7,590
Earnings per Share (EPS)	$ .27

To Statement of Stockholders' Equity

For the month

Earnings Per Share

You will note that the earnings (EPS) ratio is reported on the income statement. It is widely used in evaluating the operating performance and profitability of a company.

$$\text{Earnings per Share} = \frac{\text{Net Income}}{\text{Average No. of Shares of Common Stock Outstanding during the Period}}$$

$$\frac{\$7{,}590{,}000 \text{ Net Income}}{28{,}100{,}000 \text{ shares}} = \$0.27$$ earnings per share for the month

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
Month Ended January 31, 2009
(dollars in thousands)

	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance, December 31, 2008	$7,000	$123,000	$130,000
Additional stock issuances	2,000		2,000
Net income		7,590	7,590
Dividends declared		(3,000)	(3,000)
Ending balance, January 31, 2009	$9,000	$127,590	$136,590

From Statement of Income

From Event (a) in Chapter 2 → Additional stock issuances

From the income statement → Net income

From Event (f) in Chapter 2 → Dividends declared

Included on the balance sheet → Ending balance, January 31, 2009

To Statement of Financial Position

PAPA JOHN'S INTERNATIONAL, INC., AND SUBSIDIARIES
Consolidated Balance Sheet

Statement of Financial Position

Current Assets	
Cash	$ 41,900
Accounts receivable	21,030
Interest receivable	70
Supplies	12,000
Prepaid expenses	16,500
Other current assets	13,000
Total current assets	104,500
Investments	2,000
Property and equipment (net of accumulated depreciation of $191,500)	196,500
Notes receivable	11,000
Intangibles	77,000
Other assets	36,000
Total assets	$427,000
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current Liabilities	
Accounts payable	$ 39,000
Dividends payable	3,000
Accrued expenses payable	74,300
Income tax payable	3,910
Total current liabilities	120,210
Unearned franchise fees	5,200
Notes payable	138,000
Other long-term liabilities	27,000
Total liabilities	290,410
Stockholders' Equity	
Common stock	9,000
Retained earnings	127,590
Total stockholders' equity	136,590
Total liabilities and stockholders' equity	$427,000

This is the statement of financial position drawn from the ***adjusted trial balance***..

From Statement of Stockholders' Equity →

Statement of Cash Flows

Statement of Cash Flows is a categorized list of all transactions of the period that affected the Cash account.

The three categories are . . .

1. Operating activities,
2. Investing activities, and
3. Financing activities.

SUPPLEMENTAL INFORMATION

1. Cash interest paid.
2. Cash income taxes paid.
3. A schedule of significant noncash investing and financing transactions.

Net Profit Margin

Net Profit Margin indicates how effective management is at generating profit on every dollar of sales.

$$\text{Net Profit Margin} = \frac{\text{Net Income}}{\text{Net Sales}}$$

Net profit margin for Papa John's for 2008 is:

$$\frac{\$36{,}796{,}000}{\$1{,}132{,}087{,}000} = 0.0325 = 3.25\%$$

Closing the Books

End of Accounting Cycle

- The ending balance in each of the **asset, liability, and stockholders' equity** accounts becomes the beginning account balance for the next period. These accounts are ***"Permanent Accounts"*** or ***"Real Accounts."***
- **Revenue, expense, gain, and loss** accounts are used to accumulate data for current accounting period only. These accounts are ***"Temporary Accounts"*** or ***"Nomimal Accounts."***

Closing entries:

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

Even though the statement of financial position account balances carry forward from period to period, the statement of income accounts **DO NOT**.

Closing the Books

Here is an example of the closing process using an illustration with just a few accounts.

Revenues have credit balances. Close them with debits.

Sales Revenue (−R)	100	
Gain on Sale of Assets (−R)	30	
Wages Expense (−E)		40
Loss on Sale of Assets (−E)		10
Retained Earnings (+SE)		80

Expenses have debit balances. Close them with credits.

=Net income

To transfer Net Income of $80 to Retained Earnings

CE is short for *closing entry*.

Wages Expense			
Bal.	40	40	CE
Closed	0		

Retained Earnings		
	6,000	Bal.
	80	CE
	6,080	Bal.

Sales Revenue			
CE	100	100	Bal.
		0	Closed

Loss on Sale of Assets			
Bal.	10	10	CE
Closed	0		

130 revenues − 50 expenses = 80 Net income

Gain on Sale of Assets			
CE	30	30	Bal.
		0	Closed

Closing Entries for Papa John's

PAPA JOHN'S INTERNATIONAL, INC., AND SUBSIDIARIES
Consolidated Statement of Income
For the Month Ended January 31, 2009
(dollars in thousands)

Operating Revenues	
Restaurant sales revenue	$66,000
Franchise fee revenue	4,730
Total revenues	70,730
Operating Expenses	
Cost of sales	30,000
Salaries expense	16,000
General and administrative expenses	7,000
Supplies expense	4,000
Rent expense	2,000
Insurance expense	500
Utilities expense	610
Depreciation expense	2,500
Total expenses	62,610
Operating Income	8,120
Other Items	
Investment income	1,070
Interest expense	(690)
Gain on sale of land	3,000
Income before Income Taxes	11,500
Income tax expense	3,910
Net Income	$ 7,590
Earnings per Share (EPS)	$ .27

Revenues have credit balances. Close them with debits.

Expenses have debit balances. Close them with credits.

Closing Entries

Restaurant Sales Revenue (−R)	66,000	
Franchise Fee Revenue (−R)	4,730	
Investment Income (−R)	1,070	
Gain on Sale of Land (−R)	3,000	
Cost of Sales (−E)		30,000
Salaries Expense (−E)		16,000
General and Administrative Expenses (−E)		7,000
Supplies Expense (−E)		4,000
Rent Expense (−E)		2,000
Insurance Expense (−E)		500
Utilities Expense (−E)		610
Depreciation Expense (−E)		2,500
Interest Expense (−E)		690
Income Tax Expense (−E)		3,910
Retained Earnings (+SE)		7,590

After the book is closed, all revenue, expense, gain and loss accounts will have a zero balance.

"Net income" is transferred to Retained Earnings

Post-Closing Trial Balance

PAPA JOHN'S INTERNATIONAL, INC.
Trial Balance at January 31, 2009
(dollars in thousands)

	Post-Closing Trial Balance	
	Debit	**Credit**
Cash	41,900	
Accounts receivable	21,030	
Interest receivable	70	
Supplies	12,000	
Prepaid expenses	16,500	
Other current assets	13,000	
Investments (long-term)	2,000	
Property and equipment	388,000	
Accumulated depreciation		191,500
Notes receivable (long-term)	11,000	
Intangibles	77,000	
Other assets	36,000	
Accounts payable		39,000
Dividends payable		3,000
Accrued expenses payable		74,300
Income tax payable		3,910
Unearned franchise fees		5,200
Notes payable (long-term)		138,000
Other long-term liabilities		27,000
Common stock		9,000
Retained earnings		127,590

All ***temporary accounts*** have been **CLOSED**. Only balances of ***permanent accounts*** (assets, liabilities, stockholders' equity) will become the beginning account balances for the next period.

After closing, this is retained earnings at Jan 31, 2009

CHAPTER 4: ADJUSTMENTS, FINANCIAL STATEMENTS, AND THE QUALITY OF EARNINGS

An unadjusted trial balance of Deana's Decorators dated December 31, 2014 is as follows.

DEANA'S DECORATORS
Unadjusted Trial Balance
December 31, 2014

Accounts	Debit	Credit
Cash	43,450	
Supplies	1,800	
Accounts Receivable	4,000	
Prepaid Rent	12,000	
Prepaid Insurance	6,000	
Certificate of Deposit	20,000	
Interest Receivable	0	
Property, Plant & Equipment	40,000	
Accumulated Depreciation		0
Accounts Payable		250
Dividend Payable		0
Unearned Revenue		500
Notes Payable		30,000
Interest Payable		0
Income Tax Payable		0
Common Stock		10,000
Retained Earnings		0
Decorating Revenue		120,000
Investment Income		0
Wage Expense	32,000	
Utilities Expense	1,000	
Telephone Expense	500	
Supplies Expense	0	
Rent Expense	0	
Insurance Expense	0	
Depreciation Expense	0	
Interest Expense	0	
Income Tax Expense	0	
Totals	160,750	160,750

Prepare the required adjusting journal entry for each situation as of December 31, 2014.

Step 1: Analyze the information available for preparing journal entries at the end of the accounting period.

Step 2: Journalize the adjusting entries.

a. Suppose Deana's had received a $1,800 shipment of supplies in September 2014. When counting the supplies on December 31, 2014, Deana's found only $800 worth of supplies on hand.

b. Suppose Deana's had paid $12,000 for six months' rent on November 1, 2014. As of December, 31, 2014, two months' (November & December) prepaid rent has expired.

c. Suppose Deana's had paid $6,000 for one year's insurance on June 1, 2014.

d. The company had acquired Property, Plant & Equipment costing $40,000 on January 1, 2014. Suppose that the depreciation on this Equipment was calculated to be $2,000 for 2014.

e. On December 1, 2014, the company had sold $500 in gift certificates for decorating services to a customer. On December 31, 2014, the accountant received an envelope containing $400 worth of redeemed gift certificates, not yet recorded in the company's books.

f. On June 30, 2014, the company invested $20,000 in a certificate of deposit that will yield 12% interest at the end of one year.

g. The company borrowed a note payable from the bank for $30,000 on January 1, 2014, due with all interest on June 30, 2015. The note payable requires 10% interest.

h. The company calculated its income taxes as $26,110 for the year ended December 31, 2014.

i. On December 15, 2014, the company declared a $750 dividend, payable January 15, 2015.

	GENERAL JOURNAL				
	Date		Account Titles and Explanation	Debit	Credit
a.					
b.					
c.					
d.					
e.					
f.					
g.					
h.					
i.					

Step 3: Post the adjusting entries to T-accounts to bring the accounts up to date at the end of the accounting period.

Shown in the T-accounts below are the unadjusted account balances from page 1. Post the adjusting journal entries on previous page to the T-accounts below.

Assets

+ Cash –

Unadj.	43,450		

+ Supplies –

Unadj.	1,800		

+ Accounts Receivable –

Unadj.	4,000		

+ Prepaid Rent –

Unadj.	12,000		

+ Prepaid Insurance –

Unadj.	6,000		

+ Certificate of Deposit –

Unadj.	20,000		

+ Interest Receivable –

Unadj.	0		

+ Property, Plant & Equipment –

Unadj.	40,000		

- Accumulated Depr. +

		Unadj.	0

Liabilities

- Accounts Payable +

		Unadj.	250

- Dividend Payable +

		Unadj.	0

- Unearned Revenue +

		Unadj.	500

- Notes Payable +

		Unadj.	30,000

- Interest Payable +

		Unadj.	0

- Income Tax Payable +

		Unadj.	0

Stockholders' Equity

- Common Stock +

		Unadj.	10,000

- Retained Earnings +

		Unadj.	0

- Decorating Revenue +

		Unadj.	120,000

- Investment Income +

+ Wage Expense –

Unadj.	32,000		

+ Utilities Expense –

Unadj.	1,000		

+ Telephone Expense –

Unadj.	500		

+ Supplies Expense –

+ Rent Expense –

+ Insurance Expense –

+ Depreciation Expense –

+ Interest Expense –

+ Income Tax Expense –

Step 4: Prepare an adjusted trial balance as of December 31, 2014

DEANA'S DECORATORS
Trial Balance
As at December 31, 2014

[Balances from Page 1] [Closing Entry from Page 8]

Accounts	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance		Closing Entry		Post-Closing Trial Balance	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash	43,450				43,450				43,450	
Supplies	1,800									
Accounts Receivable	4,000				4,000				4,000	
Prepaid Rent	12,000									
Prepaid Insurance	6,000									
Certificate of Deposit	20,000				20,000				20,000	
Interest Receivable	0									
Property, Plant & Equipment	40,000				40,000				40,000	
Accumulated Depreciation		0								
Accounts Payable		250				250				250
Dividend Payable		0								
Unearned Revenue		500								
Notes Payable		30,000				30,000				30,000
Interest Payable		0								
Income Tax Payable		0								
Common Stock		10,000				10,000				10,000
Retained Earnings		0								
Decorating Revenue		120,000								
Investment Income		0								
Wage Expense	32,000									
Utilities Expense	1,000									
Telephone Expense	500									
Supplies Expense	0									
Rent Expense	0									
Insurance Expense	0									
Depreciation Expense	0									
Interest Expense	0									
Income Tax Expense	0									
Totals	160,750	160,750								

Step 5: Prepare the Statement of Comprehensive Income, Statement of Stockholders' Equity, and Statement of Financial Position

Use balances from the adjusted trial balance on the previous page to prepare (1) Statement of Income; (2) Statement of Stockholders' Equity; and (3) Statement of Financial Position for Deana's Decorators as of and for the year ended December 31, 2014.

DEANA'S DECORATORS
Statement of Income
For the year ended December 31, 2014

Revenues:	
Decorating revenue	_____
Investment income	_____
Total revenues	_____
Expenses:	
Wages expense	_____
Utilities expense	_____
Telephone expense	_____
Supplies expense	_____
Rent expense	_____
Insurance expense	_____
Depreciation expense	_____
Interest expense	_____
Total expenses	_____
Pretax income	_____
Less: Income tax expense	_____
Net income	_____

DEANA'S DECORATORS
Statement of Stockholders' Equity
For the year ended December 31, 2014

	Common Stock	Retained Earnings	Total Stockholders' Equity
Balance, January 1, 2014	_____	_____	_____
Net income	_____	_____	_____
Dividend	_____	_____	_____
Balance, December 31, 2014	_____	_____	_____

DEANA'S DECORATORS

Statement of Financial Position

As of December 31, 2014

Assets

Current assets	
Cash	_____
Certificate of deposit	_____
Supplies	_____
Accounts receivable	_____
Interest receivable	_____
Prepaid rent	_____
Prepaid insurance	_____
Total current assets	_____
Property, plant and equipment – net of accumulated depreciation	_____
Total assets	_____

Liabilities & Stockholders' Equity

Current liabilities	
Accounts payable	_____
Dividends payable	_____
Unearned revenue	_____
Notes payable	_____
Interest payable	_____
Income tax payable	_____
Total current liabilities	_____
Stockholders' Equity	
Common stock	_____
Retained earnings	_____
Total stockholders' equity	_____
Total liabilities & stockholders' equity	_____

Step 6: Close the book.

For Deana's Decorators, prepare the required closing entries. Post the entries to the T-accounts shown on the next page. Then, prepare a post-closing trial balance.

GENERAL JOURNAL				
Date		Account Titles and Explanation	Debit	Credit

CHAPTER 4: ADJUSTMENTS, FINANCIAL STATEMENTS, AND THE QUALITY OF EARNINGS

EXERCISE 4-1 Closing Entries of a Profitable Company

Snow White Services Limited closes its temporary accounts once each year on December 31. The company recently issued the following statement of income as part of its annual report:

SNOW WHITE SERVICE LIMITED
Statement of Income
For the Year Ended December 31, 2015

Revenue:		
Counseling revenue		$ 225,000
Expenses:		
Salaries expense	$ 100,000	
Advertising expense	4,450	
Depreciation expense	10,500	
Rent expense	24,000	
Supplies expense	1,200	
Utilities expense	850	
Income taxes expense	29,400	
Total expenses		170,400
Net profit		$ 54,600

The firm's statement of changes in equity indicates that a $6,000 cash dividend was declared and paid in 2015.

Required:

(a) Prepare the necessary closing entries on December 31, 2015.

GENERAL JOURNAL				
Date		**Account Titles and Explanation**	**Debit**	**Credit**

(b) If the firm's Retained Earnings account had a $92,000 balance on January 1, 2015, at what amount should Retained Earnings be reported in the firm's statement of financial position dated December 31, 2015?

EXERCISE 4-2 Closing Entries of Unprofitable Company

Cinderella Consulting provides risk management services to individuals and to corporate clients. The company closes its temporary accounts once each year on December 31. The company recently issued the following statement of income as part of its annual report:

CINDERELLA CONSULTING
Statement of Income
For the Year Ended December 31, 2015

Revenue:		
Consulting revenue		$ 142,200
Expenses:		
Salaries expense	$ 155,500	
Advertising expense	16,000	
Depreciation expense	24,000	
Rent expense	9,600	
Supplies expense	4,400	
Utilities expense	5,200	
Interest expense	2,500	
Total expenses		217,200
Net loss		$ (75,000)

The firm's statement of changes in equity indicates that a $25,000 cash dividend was declared and paid in 2015.

Required:

(a) Prepare the necessary closing entries on December 31, 2015.

GENERAL JOURNAL				
Date		**Account Titles and Explanation**	**Debit**	**Credit**

(b) If the firm's Retained Earnings account had a $300,000 balance on January 1, 2015, at what amount should Retained Earnings be reported in the firm's statement of financial position dated December 31, 2015?