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

AC201
Fundamental Accounting

Semester 2/2013

Course Materials

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

Session:
Sessions #5

Instructor:
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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
			• Share capital
			  • 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

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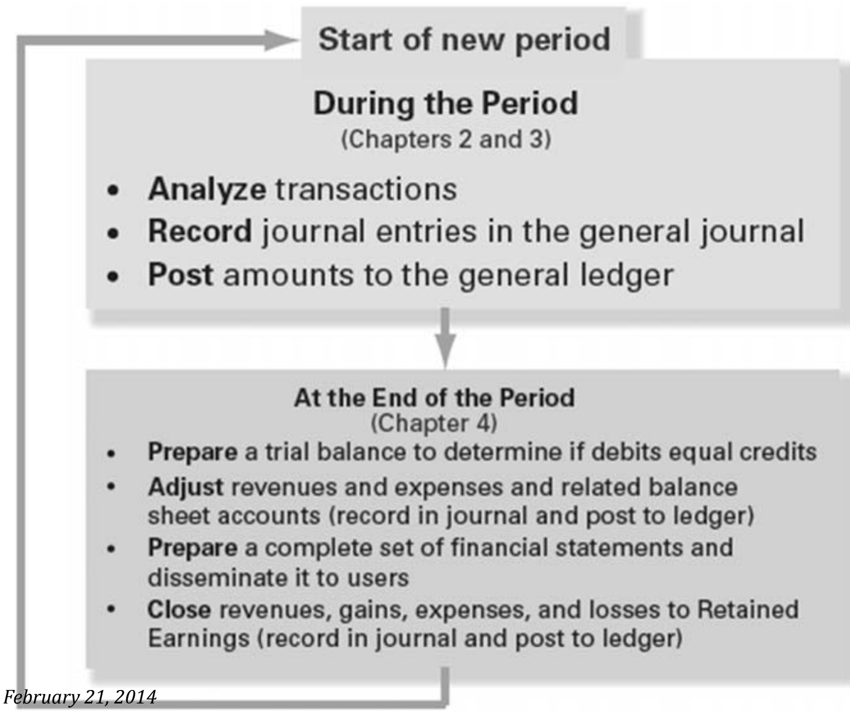
The Accounting Cycle



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
May need an accrual for any amount earned from franchisees but not yet recorded	Accounts receivable	20,200		
May need an accrual for any investment income earned but not yet recorded	Interest receivable	0		
May need an adjustment for the amount of supplies used during the period	Supplies	16,000		
May need an adjustment for the amount of rent and insurance used during period	Prepaid expenses	19,000		
	Other current assets	13,000		
	Investments (long-term)	2,000		
Represents the historical cost of property and equipment	Property and equipment	388,000		
Represents the total amount of the cost of property and equipment used in the past	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	
May need an accrual for any wages, utilities, and interest incurred	Accrued expenses payable		71,000	
Needs an accrual for the amount of income tax expense incurred during period	Income tax payable		0	
May need an adjustment for the amount earned during period	Unearned franchise fees		6,300	
	Notes payable (long-term)		138,000	
	Other long-term liabilities		27,000	
	Contributed capital		9,000	Stockholders' Equity — E
Represents the beginning balance of retained earnings minus dividends declared during the month ($123,000 − $3,000)	Retained earnings		120,000	

For reporting purposes:

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

Unadjusted Trial Balance

Revenue from selling pizza and ingredients plus equipment to franchisees	Restaurant sales revenue		66,000	*Revenues and Gains* REV
Revenue from selling franchises during the period	Franchise fee revenue		2,800	
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* EXP
Expense for rent used during period	Rent expense	0		
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.

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

- The journal entries that bring the accounts up to date at the end of the accounting period are called ***ADJUSTING ENTRIES***.
- All adjusting entries affect at least one statement of income account and one statement of financial position account.

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:

I. Converting liabilities to revenue.
II. Accruing uncollected revenue.
III. Converting assets to expenses.
IV. Accruing unpaid expenses.

Adjusting Entries – When Revenue is Earned

When revenue is earned, the adjusting entry is:

DEFERRED REVENUE
if cash was received and previously recorded

Journal entry at the time cash was received

Cash (+A)	xx	
Deferred (unearned) revenue (+L)		xx

I. Converting liability to revenue

Adjusting entry at end of period

Deferred (unearned) revenue (-L)	xx	
Revenue (+REVE, +SE)		xx

Increase revenues

OR

ACCRUED REVENUE
if cash will be received

II. Accruing uncollected revenue

Adjusting entry at end of period

Receivable (+A)	xx	
Revenue (+R, +SE)		xx

Increase revenues

Adjusting Entries – When Expense is Incurred

When expense is incurred, the adjusting entry is:

DEFERRED EXPENSE
if cash was paid and previously recorded

Journal entry at the time cash was paid

Deferred (prepaid) expense (+A)	xx	
Cash (-A)		xx

III. Converting assets to expenses

Adjusting entry at end of period

Expense (+E, -SE)	xx	
Deferred (prepaid) expense (-A)		xx

Increase expenses

OR

ACCRUED EXPENSE
if cash will be paid

IV. Accruing unpaid expenses

Adjusting entry at end of period

Expense (+E, -SE)	xx	
Payable (+L)		xx

Increase 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

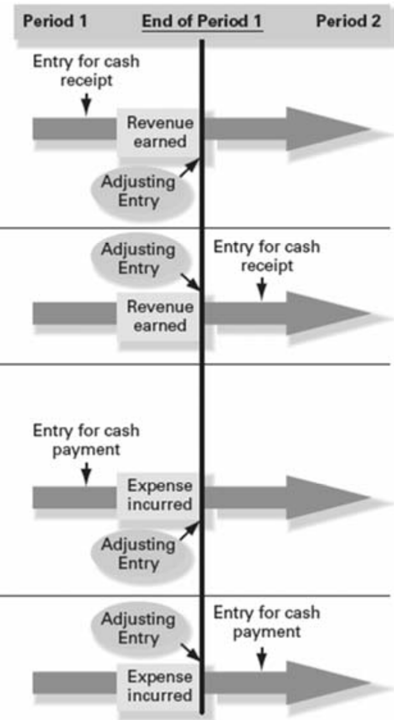
Adjusting Entries that Increase **Expenses**:

- 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



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Adjusting Entries: An Illustration

Deferred Revenue (or Unearned Revenue)

Papa John's received cash last period 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)

Accrued Revenue (1)

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.

II. Accruing uncollected revenue

This adjusting entry is made on Jan 31, 2009

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)

Accrued Revenue (2)

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 was also $8,000 in notes receivable outstanding all month from prior loans.
There are two components when lending or borrowing money:
principal (the amount loaned or borrowed)
and ***interest*** (the cost of borrowing).
Notes Receivable (the principal) was recorded properly when the money was loaned.

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Accrued Revenue (3)

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.				

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)

Deferred Expense (or Prepaid Expense) (1)

Prepaid Expenses includes:

- $2,000 paid on January 1 for insurance coverage for four months (January through April), and
- $6,000 paid on January 1 for rental of space at shopping centers over three months (January through March)

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.

Deferred Expense (or 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)

Deferred Expense (or Prepaid Expense) (3)

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.

Computation of Supplies Expense:

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

Deferred Expense (or Prepaid Expense) (4)

This adjusting entry is made on Jan 31, 2009

III. Converting assets to expenses

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)