

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

CHAPTER SUMMARY

An accounting system is designed to collect, process, and report financial information. During each period, an accounting information processing cycle starts with analyzing and recording transactions (data collection) and ends with the preparation of the required financial statements. It is also necessary for the nominal (temporary) accounts to be closed.

Adjustments to some accounts are necessary before preparing financial statements because of the timing differences of recording cash receipts and payments versus proper recognition of revenues and expenses. The accounting model from Chapters 2 & 3 provides the basic framework for the adjustment process. At the end of the accounting period, accounts must be analyzed to determine if adjustments are required. Accrual and deferral accounts must be updated to reflect revenues earned and expenses incurred during the period to comply with the revenue recognition and matching principles. Adjusting journal entries are posted to the ledger, and an adjusted trial balance is prepared. The adjusted trial balance is the primary source of data for the preparation of the formal financial statements.

The formal financial statements are related. The Income Statement must be prepared first because net income flows to the Statement of Stockholders' Equity. Ending retained earnings from the Statement of Stockholders' Equity is carried to the Balance Sheet.

Revenue and expense accounts are temporary accounts. They reflect activities for a single accounting period. The balances in these accounts must be zero at the beginning of each accounting period. At the end of the accounting period, the temporary accounts have to be emptied out so that they will have zero balances at the start of the next period. Balances from these accounts are transferred to retained earnings.

Balance sheet accounts are permanent accounts. Their balances carry from one accounting period to the next, so it is not necessary to close these accounts.

A post-closing trial balance is the last step. It is a final check of accuracy.

CHAPTER OBJECTIVES

- LO1 Explain the purpose of adjustments and analyze the adjustments necessary at the end of the period to update balance sheet and income statement accounts.
- LO2 Explain the purpose of a trial balance.
- LO3 Present an income statement with earnings per share, statement of stockholders' equity, and balance sheet, and supplemental cash flow information.
- LO4 Compute and interpret the net profit margin.
- LO5 Explain the closing process.

CHAPTER OUTLINE

I. UNDERSTANDING THE BUSINESS

- 1.** Management is responsible for preparing the financial statements of a company that are used by investors, creditors, and others.
- 2.** The financial statement information should be relevant (timely) and reliable (verifiable and unbiased). The result of this high quality information is that it is useful in analyzing the past and predicting the future.
- 3.** Following the revenue recognition principle (recognizing revenue when earned, rather than when cash is received) and the matching principle (recognizing expenses when incurred rather than when cash is paid) requires adjustments of revenue and expense accounts.
- 4.** Measuring revenue and expense items requires managers to make estimates.
- 5.** The adjusting process goes beyond the day-to-day bookkeeping function. It requires a great deal of knowledge, judgment, and experience. As such, manipulation of income needs to be closely scrutinized. This is an ethical issue.
- 6.** The closing process clears all temporary accounts to a zero balance so they are ready for the accumulation of amounts in the new period.

II. LO1 Explain the purpose of adjustments and analyze the adjustments necessary at the end of the period to update balance sheet and income statement accounts.

- 1.** Purpose of adjustments:
 - A.** There are differences between when cash is received and when revenue is earned (accrual vs. cash basis accounting).
 - B.** There are differences between when cash is paid and expenses incurred.
 - C.** Both of the above (A and B) are called timing differences.
 - D.** The solution to the problem created by timing differences is solved by adjusting entries. Adjusting entries are prepared at the end of an accounting period so that:
 - Revenues are recorded when earned (the revenue principle)
 - Expenses are recorded when incurred to generate revenue (the matching principle)
 - Assets are reported at amounts that represent the probable future benefit remaining at the end of the period, and
 - Liabilities are reported at amounts that represent the probable future sacrifices of assets or services owed at the end of the period.
 - E.** Adjustments are required every time the company wants to prepare financial statements for external users
- 2.** Analyze the adjustments necessary at the end of the period to update the balance sheet and the income statement accounts:
 - A.** All adjustments involve two entries
 - 1.** One of cash receipts or cash payments
 - 2.** One to record the revenue or expense in the proper period (the adjusting entry)
 - B.** Types of adjustments:
 - 1.** Unearned revenues
 - 2.** Accrued revenues
 - 3.** Prepaid expenses
 - 4.** Accrued expenses
 - C.** Analyzing adjustments:
 - 1.** Identify the type of adjustment
 - 2.** Determine the amount of the adjustment
 - 3.** Record the adjusting journal entry (in the journal)
 - 4.** Post the adjusting entry to the ledger

D. Examples of adjustments:

1. Recognizing revenues in the proper period
 - a. Unearned revenue: Cash is received before it is earned (product delivered or service performed).
 - Initially recorded as a liability
 - Considered a deferred revenue account
 - Adjusting entry reduces the liability and increases the revenue to recognize the amount of the debt that has been satisfied
 - b. Accrued revenue: Previously unrecorded revenues.
 - Adjusting entry increases revenue and increases the related receivable (the right to receive payment in the future).
2. Recognizing expenses in the proper period
 - a. Deferred expense: Cash is paid before expense is incurred.
 - Initially recorded as an asset. (Supplies, prepayments)
 - Adjusting entry reduces the asset and increases the expense to recognize the amount of the asset that has been used.
 - b. Accrued expense: Previously unrecorded expense.
 - Adjusting entry increases expense and increases the related liability (the obligation to pay in the future).
3. Recognizing expenses in the proper period
 - a. The adjustment process
 - Identify whether the adjustment is to an existing deferred revenue, expense, or to an unrecorded accrued revenue or expense.
 - Compute the revenue earned or expense incurred in the accounting period.
 - Record the adjusting journal entry.
4. Property and equipment
 - a. Plant assets (buildings, equipment, etc.) are used to generate revenue.
 - b. To comply with the matching principle, a portion of their cost should be expensed in the same period as the revenue they helped to produce.
 - Depreciation expense allocates a portion of the cost of the asset to the accounting period.
 - Depreciated value has no relationship to fair market value.
 - Depreciation is simply a method of cost allocation.
 - A contra asset account is used to offset the asset.

III. LO2 Explain the purpose of a trial balance.

1. A trial balance is a list of accounts and their balances at a given time.
 - a. The primary purpose of the trial balance is to prove the mathematical equality of debits and credits after posting.
 - b. A trial balance helps to uncover errors in journalizing and posting, but does not prove that everything is correct!
 - c. A trial balance is limited in that it will balance, and therefore not uncover errors when:
 1. A transaction is not journalized,
 2. A correct journal entry is not posted,
 3. A journal entry is posted twice,
 4. Incorrect accounts are used in journalizing and posting,
 5. Offsetting errors are made in recording the amount of a transaction.
2. Unadjusted trial balance
 - a. Prepared at the end of the accounting cycle.
 - b. Reflects balances in all accounts before adjustment.

3. A six-column worksheet can be used to prepare both the unadjusted and adjusted trial balance. The first two columns (debt and credit) are used to prepare the unadjusted trial balance. The second two columns (debt and credit) are used to input the adjustments. The third two columns (debt and credit) are used to present the adjusted trial balance.

IV. LO3 Present an income statement with earnings per share, statement of stockholders' equity, and balance sheet, and supplemental cash flow information.

1. Adjusted trial balance provides the raw data for the preparation of the balance sheet and the income statement.
2. Order of statement preparation:
 - a. Income Statement prepared first, since net income must be carried to Statement of Stockholders' Equity (or Retained Earnings Statement).
 - b. Statement of Stockholders' Equity (or Retained Earnings Statement) would be prepared next, because ending retained earnings must be determined for the Balance Sheet.
 - c. The Balance Sheet is prepared next, since all necessary information is available.
 - d. Statement of Cash Flows is prepared in conjunction with other statements.
3. Income Statement
 - a. Tells the story of what happened during the accounting period.
 - b. Revenues – Expenses = Net Income (Net Loss)
 - c. Also referred to as P&L (Profit and Loss) Statement
 - d. Corporations are required to present EPS (Earnings per share) either in the income statement or in the Notes. For simple capital structures, it is calculated as follows:

$$\text{EPS} = \frac{\text{Net income}^*}{\text{Average number of common shares outstanding}}$$

*If there are preferred dividends, the amount is subtracted from net income.

4. Statement of Stockholders' Equity
 - a. Shows changes in all parts of stockholders' equity during the year.
 1. Changes in retained earnings during the period:

Beginning retained earnings	
+ Net income (or – net loss)	
- Dividends	
<hr/>	
Ending retained earnings	

Some companies just show the changes in retained earnings. This is called a Statement of Retained Earnings.

2. Changes in contributed capital during the period.

Beginning contributed capital	
+ Stock issues	
- Stock repurchases and retirements	
<hr/>	
Ending contributed capital	

5. Balance Sheet
 - a. A snapshot of a company's financial position at a particular point in time – the end of business on the date of the statement.
 - b. Assets = Liabilities + Stockholders' Equity
 1. What the company owns, what the company owes, and the "residual" owners' equity on that date.
 2. Assets are presented in order of liquidity; liabilities are presented in order of due dates.
 3. The ending balances are used on the balance sheet for retained earnings and contributed capital.

6. Cash Flow Statement
 - a. Explains the difference between the beginning and ending cash balance.
 - b. The cash flow statement is a categorized list of all transactions for the period that affect the cash account.
 - c. Three classifications: Operating, Investing, and Financing.
 - d. Supplemental information is included for interest paid, income taxes paid, and a schedule of non-cash investing and financing activities.

V. LO4 Compute and interpret the net profit margin.

1. Net profit margin answers the question: How effective is management in generating profit on every dollar of sales? In other words, each dollar of sales results in how much profit?
2. Calculated as follows:

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

3. This is compared with other companies in the industry and with the net profit margin from prior periods in order to determine deterioration or improvement.

VI. LO5 Explain the closing process.

1. End of the Accounting Cycle
 - a. Real (permanent) accounts are the accounts listed on the balance sheet and carry over balances from one accounting period to the next. These are the balance sheet accounts (assets, liabilities, and owners' equity).
 - b. Nominal (temporary) accounts are closed at the end of the accounting period.
 1. Income statement accounts (revenues and expenses) and the dividend account are temporary accounts.
 2. Accumulate amounts for the accounting period.
 3. Must be closed out (emptied) so that they are ready to start the accumulation process for the next accounting period.
 4. Income statement tells the story of what happened just during a particular period of time, so these accounts must start with zero balances at the beginning of the period so that they will reflect events only for that particular period.
 - c. Closing entries "zero out" the temporary accounts.
 1. If a temporary account has a debit balance, it must be credited for the amount of its balance.
 2. If a temporary account has a credit balance, it must be debited for the amount of its balance.
 3. The offset in the closing entries is to retained earnings.
 4. The net effect is that retained earnings is increased (or decreased) by the net of revenues minus expenses (net income or loss for the period), and decreased by the amount of dividends declared.
2. Post-Closing Trial Balance
 - a. After closing entries have been posted, a post-closing trial balance is prepared.
 1. This is a list of all of the remaining accounts and their balances.
 2. Only balance sheet accounts will remain.
 - b. Reason for post-closing trial balance:
 1. Ensure that debits = credits to start the new accounting period.
 2. Ensure that no temporary account balances remain. All temporary accounts should have zero balances at this point.