Deferred Expense (or Prepaid Expense) (5)

Property and equipment are assets that have a normal debit balance. **Depreciation is the allocation of the cost of an asset over its estimated useful life to the company.** ***Depreciation*** is an expense with a normal debit balance. 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. We subtract accumulated depreciation from the cost of our property and equipment to arrive at net book value.

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

–

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

Deferred Expense (or Prepaid Expense) (6)

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

This adjusting entry is made on Jan 31, 2009

III. Converting assets to expenses

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 (1)

Papa John's owed
(1) its employees salaries for working four days at the end of January at $500 per day,
(2) $610 for utilities used in January, and
(3) interest on its long-term notes payable borrowed at a 6 percent annual rate.

Amounts for Accrued Expenses:
1. Salaries = $500 per day × 4 days = $2,000
2. Utilities = $610
3. Interest = $138,000 × .06 × 1/12 = $690

Accrued Expenses (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)

Accrued Expenses – 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):

From our unadjusted trial balance shown earlier

	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

Accrued Expenses – 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 × .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
Contributed capital		9,000				9,000
Retained earnings		120,000				120,000

A

L

E

To prepare Statement of Financial Position

Adjusted Trial Balance

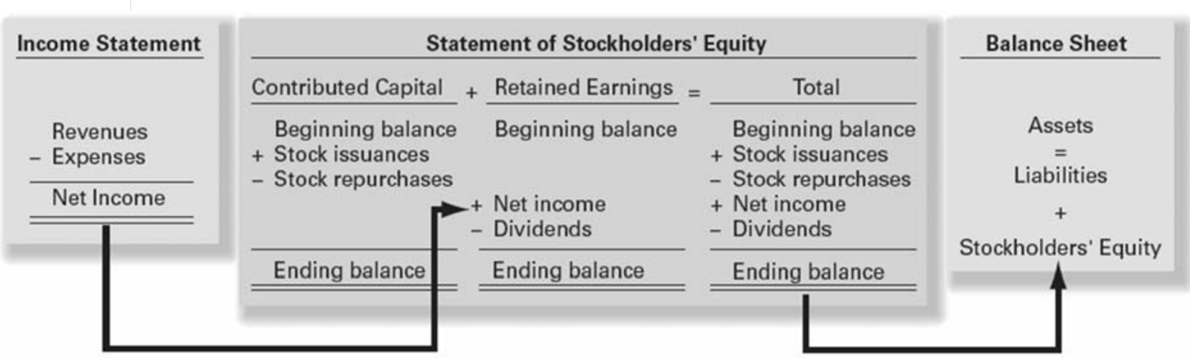
Restaurant sales revenue		66,000				66,000
Franchise fee revenue		2,800		AJE 1 1,100 AJE 2 830		4,730
Investment income		1,000		AJE 3 70		1,070
Gain on sale of land		3,000				3,000
Cost of sales	30,000				30,000	
Salaries expense	14,000		AJE 7 2,000		16,000	
General and administrative expenses	7,000				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

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

For the month

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.

To Statement of Stockholders' Equity

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)

		Contributed Capital	Retained Earnings	Total Stockholders' Equity
	Beginning balance, December 31, 2008	$7,000	$123,000	$130,000
From Event (a) in Chapter 2	Additional stock issuances	2,000		2,000
From the income statement	Net income		7,590	7,590
From Event (f) in Chapter 2	Dividends declared		(3,000)	(3,000)
Included on the balance sheet	Ending balance, January 31, 2009	$9,000	$127,590	$136,590

From Statement of Income

To Statement of Financial Position

Statement of Financial Position

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

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	
Contributed capital	9,000
Retained earnings	127,590
Total stockholders' equity	136,590
Total liabilities and stockholders' equity	$427,000

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:

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

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		

Loss on Sale of Assets

Bal.	10	10	CE
Closed	0		

Retained Earnings

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

130 revenues − 50 expenses = 80 Net income

Sales Revenue

CE	100	100	Bal.
		0	Closed

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

A Closing Entry

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

All revenue, expense, gain and loss accounts will have a zero balance.

To transfer net income 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
Contributed capital		9,000
Retained earnings		127,590

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

This is now retained earnings at Jan 31, 2009

End of Chapter 4