

Busi 293 Notes

Chapter Four

Adjustments, Financial Statements, and the Quality of Earnings

ADJUSTMENTS

In the last three chapters we have learned that an entity needs to record all transactions. In a perfect world, a company would record all transactions each day and therefore never need to make any adjustments at the end of an accounting period. Given the volume of transactions and the delays encountered in practice, perfection is not possible.

The need for timely and complete information requires management to prepare information monthly, quarterly, and annually. While adjustments may be required any time financial statements are prepared, let's assume for this chapter that we are preparing the year end annual financial statements. Most companies, regardless of size, will have a computerized accounting package. Accountants and bookkeepers will have inputted accounting transactions throughout the year.

The starting point for the preparation of financial statements is the Unadjusted Trial Balance. Please refer to textbook Reference A which provides a listing of the balances in each account of the chart of accounts at the end of the year. Notice the ordering of the listing - Assets, Liabilities, Shareholder Equity Accounts, Revenues, Gains, Expenses and Losses. The debit and credit columns must be balanced before we proceed. In practice I usually go through each account to determine whether each account is in its normal debit or credit balance.

Remember Assets, Expenses and Losses are usually in a debit position while Liabilities, Equity accounts, Revenues and Gains are in a credit position. As with everything there are always exceptions - Accumulated Amortization and Allowance for Doubtful Accounts are in credit balances. These two accounts are known as contra accounts as they offset Property, Plant and Equipment and Accounts Receivable respectively. As a point of interest some companies use the term depreciation instead of amortization.

While there are many reasons why the debit and credit columns do not equal, here are some of the more common ones;

- A debit entry is posted as a credit or vice versa
- One side of the entry is not posted (i.e. the debit is posted but not the credit is not)
- An amount on one side of the journal entry is posted incorrectly – i.e. 69 is posted at 96 (transposition error) or 96 is posted as 960 (slide error).

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The important issue to determine is whether all transactions have been recorded correctly! Only accountants with a firm understanding of the business will be able to address this issue. If the answer is yes, then no further adjustments will be required. If the answer is no, which will usually be the case, ADJUSTING JOURNAL ENTRIES WILL BE REQUIRED.

Always remember that Adjusting journal entries never involve cash.

Accountants need to review the accounts and determine which, if any, accounts need to be adjusted. Let's look at some of those accounts on the next pages:

REVENUE

(In these examples the term Sales and Revenue are used interchangeably)

- Revenue could be under- or overstated.
- Revenue could be understated because the company has not yet recorded revenue which has been earned. Often work is completed or sales are made in the last few days of the year. The adjusting journal entry to record or accrue revenue is:

Dr Trade receivable
Cr Sales revenue

This is known as the accrual of revenue.

- Revenue may also be understated because management has not recognized revenue which is presently recorded in the Unearned or Deferred Revenue account. A company may have received payments in advance of supplying a service or selling a product. When the funds were received they were recorded in the Unearned Revenue account (i.e. a liability account). During the year, the service was provided or goods sold but the amount was never transferred to the revenue account. At year end it is important to adjust the Unearned Revenue account and properly record the revenue. The adjusting journal entry is:

Dr Unearned revenue
Cr Sales revenue

- Revenue could also be overstated. This usually arises when a company receives and records a payment from a customer as revenue prior to sale actually being finalized or the service being provided. If the sale is not completed or the service is not provided prior to the year end, revenue will be overstated. The adjusting journal entry to correct this situation is:

Dr Sales revenue
Cr Unearned revenue

Unearned or Deferred revenue is a liability as it represents an obligation which must be satisfied - i.e. the company must deliver the product or render the services.

- Revenue may also be recorded prematurely- the principles of revenue recognition have not been met but the company has been aggressive and simply recognized revenue prematurely. This is often referred to as fraudulent financial reporting. Such revenue should be reversed until such time as the revenue has been earned.

In order to make an adjusting journal entry you have to determine how the client originally recorded the transaction. Don't memorize adjustments. Figure out what the client has done and what the ending balance in each account should be. Refer to the account balance in the trial balance. The difference between what is in the account and what the balance should be will provide you with the information needed to create the necessary adjusting journal entry.

A simple example will help reinforce this concept:

Facts

Assume a customer pays \$1,000 to your client during the year. The payment represents payment for a product your client believes they will be able to deliver before the year end.

At year end only \$700 of the product has actually been shipped to the customer. The following summarizes two ways your client may have recorded the transactions.

A) Client initially records the receipt of cash as revenue

Dr Cash	1,000	
Cr Sales revenue		1,000

At year end since only \$700 of product has been sold, an adjusting journal entry must be necessary

Dr Sales revenue	300	
Cr Unearned revenue		300

B) Client initially records the receipt of cash as Unearned Revenue

Dr Cash	1,000	
Cr Unearned revenue		1,000

At year end since only \$700 of product has been sold, an adjusting journal entry must be necessary

Dr Unearned revenue	700	
Cr Sales revenue		700

What I want you to see is that the ending balances in all accounts under both scenarios are the same – Sales revenue is \$700 and Unearned revenue is \$300 **BUT** the adjusting journal entries were different because the original transactions were recorded differently.

Expenses

- As with revenues, expenses must also be carefully reviewed. Expenses could also be over- or understated.
- It is probable that expenses have been incurred but the company has not yet received an invoice from a supplier and therefore has not yet recorded the transaction. Remember expenses incurred in the period to generate revenue recorded in the period must be recorded in the same period (the matching principle). When a company needs to record an expense which has not yet been recorded in the records the adjusting journal entry is:

Dr Expense
Cr Accounts payable or Accrued liabilities

This is known as the Accrual of expenses.

- Expenses could also be understated due to the following circumstance. Assume a company prepaid a one-year Insurance policy in January and recorded the payment in the Prepaid Insurance account (i.e. an asset account). At year end, assume the Company has not yet transferred the amount from Prepaid Insurance to Insurance expense. An adjusting journal entry would be necessary to make the transfer at year end because the policy has expired. The adjusting journal entry would be:

Dr Insurance expense
Cr Prepaid Insurance expense

- Although less frequent, it is possible for an expense to be overstated. The most frequent example occurs when payment for an item is initially recorded in an expense account but the payment covers a period greater than the current period (i.e. some of the expense relates to future periods). For example, assume a company paid a two-year insurance policy for \$2,400 on January 1, 2014 and recorded the payment in Insurance expense account. At the end of 2014(December 31), do you see that only half of the policy has been used and therefore only half of the fee should be expensed? In this case the adjusting journal entry should be:

Dr	Prepaid Insurance expense	1,200	
Cr	Insurance expense		1,200

Note that anytime you see the word Prepaid or Prepayments in the account name the account represents an asset - Prepaid Insurance expense is an asset not an expense.

Internal Allocations

Although we have not yet discussed depreciation expense in detail, often an adjusting journal entry will be required to record or adjust Depreciation expense. In simplest terms, depreciation represents the amount on an asset consumed in the year. While depreciation can be calculated in many ways, straight-line depreciation is calculated as follows:

$$\text{Annual depreciation} = \frac{\text{Cost of the asset} - \text{residual value}^{(*)}}{\text{Useful life in years}}$$

- (*) Residual value is the amount the entity expects to be currently obtainable from the sale of the asset if the asset has the age and condition expected at the end of the asset's useful life.

The adjusting journal entry to record or adjust depreciation is:

Dr Depreciation expense
Cr Accumulated depreciation

Remember that Accumulated depreciation is a contra account - it offsets the related asset account (companion account) and should be in a credit balance.

Materiality

In practice only material adjusting journal entries will usually be recorded – i.e. those that would make a difference to the users of the financial statements. Materiality is usually defined as a % of assets (1 -2%) or a % of net income (5 -10%). In our questions and exams assume any difference is material.

Once the adjusting journal entries have been prepared, they will be entered onto a worksheet. Please refer to textbook Reference B. Notice that each entry is referenced by either a number or letter. Again check to see that debits equals the credits. You cannot proceed until they are in balance.

The extended columns are known as the **Adjusted Trial Balance** which should now contain the correct year end balances in each account. We can now proceed to create the financial statements. Remember the ordering of the accounts in the trial balance will assist in the preparation of the statements.

Prepare the Statement of Earnings

While there are many variations, textbook Reference C presents a good example of an Statement of Earnings. Note the proper title and the period of time covered by the statement, the alignment of the numbers, underlines and double underlines. Notice how they have bolded titles and numbers. This is the first statement usually prepared. Companies reporting under IFRS would prepare a Statement of Comprehensive Income.

Earnings per share calculations are disclosed at the bottom of the statement are widely used by financial analysts.

Prepare the Statement of Changes in Equity

This statement reconciles the opening balances in each of share capital, retained earnings, and other components. Comprehensive income from the statement of comprehensive income will be transferred onto this statement as will any dividends declared in the period. Remember that only companies reporting under IFRS will report comprehensive income and other components in the equity section of the Statement of Financial Position.

Prepare the Statement of Financial Position

Now that we have have determined ending retained earnings we can complete the Statement of Financial Position - Assets, Liabilities and Shareholders' Equity. Shareholders' Equity includes Share Capital, ending Retained Earnings and Other Components.

Prepare the Statement of Cash Flows

We will leave the Statement of Cash Flows until the end of the course. We will return to Chapter 5 once we have looked at the details of each of the other chapters. Remember this statement addresses the sources and uses of cash during the period.

Prepare the Notes to the Financial Statements

While not addressed in this course, the preparation of meaningful notes is critical to a complete set of financial statements.

FINANCIAL ANALYSIS

RATIOS

Net Profit Margin - measures the portion of each sales dollar which is profit (this is not the same as gross profit margin)

Calculation

= Net Earnings/Net Sales

The higher ratio indicates management is performing well in generating a profit margin from each dollar of sales.

Return on Equity – measures how well management has used the shareholders' investments. Has a reasonable return been generated?

Calculation

= Net Earnings/Average Shareholders' Equity(*)

(*) = (beginning + ending Shareholders' Equity)/2

CLOSING ENTRIES

At the end of the year, management must ready itself for a new year. Some accounts known as permanent (real) accounts will never be closed - i.e. assets and liabilities. Other accounts, known as temporary (nominal) accounts, must be reset to zero - i.e. revenues, expenses, gains, losses, dividends declared.

In a computerized environment, you press a button for the closing process and everything is done for you. In a manual system the process is as follows:

- Close all revenue and gain accounts to an account known as the Income Summary or Retained Earnings.
- Close all expense and loss accounts to the Income Summary or Retained Earnings.

The balance in the Income Summary must equal the net earnings (loss) from the Statement of Earnings or you have made an error.

- Transfer the balance in the Income Summary to the Retained Earnings account
- Close dividends declared to Retained Earnings
- The ending balance in Retained Earnings must equal the balance of Retained Earnings on the Balance Sheet

Please refer to textbook Reference D for examples of closing entries. Remember, the ending balances on the post-closing trial balance should equal the balances on the Statement of Financial Position.

YOU ARE READY TO START THE PROCESS FOR THE NEXT YEAR!