Chapter 4

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Adjustments, Financial Statements, and the Quality of Earnings

By Yunhao Cao, for UGBA 102A Spring 2022 by Prof. Gary Pieroni.

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The end of the accounting period is very busy. Although the fiscal year for a company usually falls on the last day of December each year, the financial statements are not distributed to users until management and the external auditors(independent CPAs).

- Management at the corporate headquarters must **ensure that the correct amounts are reported** on the balance sheet and income statement. This often requires **estimations, assumptions, and judgments about the timing of revenue and expense recognition** and values for assets and liabilities.
- The auditors have to
    - assess the strength of the controls established by management to safeguard the company's assets and ensure the accuracy of the financial records
    - evaluate the appropriateness of estimates and accounting principles used by management in determining revenues and expenses.

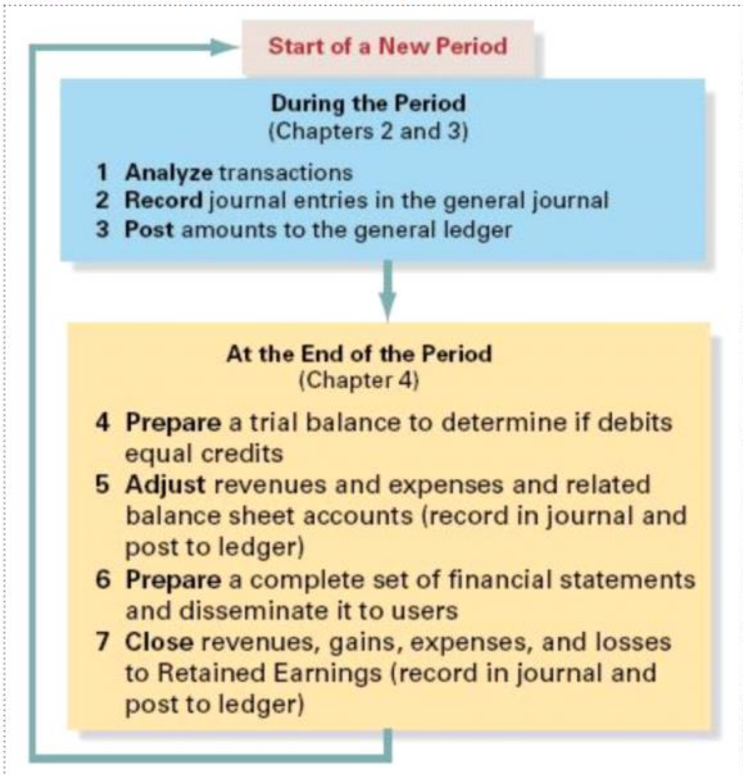
Understanding The Business

Financial information is most useful for analyzing the past and predicting the future when it is considered by users to be of **high quality.** Highquality information is information that is relevant (that is, material and able to influence users' decisions) and a faithful representation of what is being reported (that is, complete, free from error, and unbiased in portraying economic reality).

Many operating activities take place over a period of time or over several periods, such as using insurance that has been prepaid or owing wages to employees for past work. Because recording these and similar activities daily is often very costly, most companies wait until the end of the period (annually, but monthly and quarterly as well) to make **adjustments** to record related revenues and expenses in the correct period. These entries update the records and are the focus of this chapter.

Again, Accounting Cycle

EXHIBIT 4.1 The Accounting Cycle



Purpose of Adjustments

- Revenues are recorded when they are earned (the **revenue recognition principle**),
- Expenses are recorded when they are incurred to generate revenue (the **expense recognition principle**),
- **Assets** are reported at amounts that represent the probable future benefits 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.

Companies wait until the **end of the accounting period** to adjust their accounts in this way because adjusting the records daily would be very costly and time-consuming. Adjusting entries are required every time a company wants to prepare financial statements for external users.

Types of Adjustments

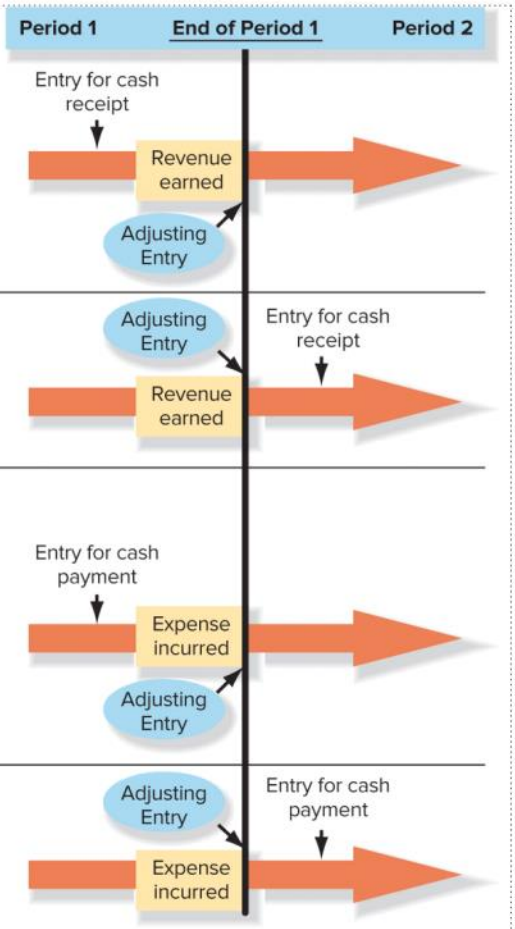
EXHIBIT 4.2 Four Types of Adjustments

Adjusting Entries that Increase Revenues:

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

Adjusting Entries that Increase Expenses:

- **Deferred Expenses** – Previously recorded assets, such as Prepaid Rent, Supplies, and Equipment, that were created when cash was paid by the company in advance of the asset being used and that must be reduced for the amount of expense actually incurred during the period through use of the asset.
- **Accrued Expenses** – Expenses that have been incurred but not yet recorded because cash will be paid after the goods or services are used.



Adjustment Process

EXHIBIT 4.3 Adjustment Process

Step 1: **Ask:** **Was revenue earned or an expense incurred that is not yet recorded?**

If the answer is YES, credit (increase) the revenue account or debit (increase) the expense account in the adjusting entry.

Step 2: **Ask:** **Was the related cash received or paid in the past or will it be received or paid in the future?**

If cash **was received** in the past, a deferred revenue (liability) account was recorded in the past → Now, reduce (debit) the liability account (usually Unearned Revenue or Deferred Revenue) that was recorded when cash was received. This is because some or all of the amount in the liability account has been satisfied (settled) since then, resulting in revenue being earned.

If cash **will be received** in the future → Increase (debit) the receivable account (such as Interest Receivable or Rent Receivable) to record what is owed by others to the company (creating an accrued revenue).

If cash **was paid** in the past, a deferred expense account (asset) was created in the past → Now reduce (credit) the asset account (such as Supplies or Prepaid Expenses) that was recorded in the past because some or all of the asset has been used since then. [A variation of this for the use of buildings, equipment, and some intangible assets follows the same concept but the difference will be illustrated.]

If cash **will be paid** in the future → Increase the payable account (such as Interest Payable or Wages Payable) to record what is owed by the company to others (creating an accrued expense).

NOTE: Cash is never included in an adjusting entry because it was recorded already in the past or will be recorded in the future.

Step 3: **Compute the amount of revenue earned or expense incurred.** Sometimes the amount is given or known, sometimes it must be computed, and sometimes it must be estimated.

The pattern that results when the adjusting entry is recorded is as follows:

When revenue is earned:		
DEFERRED REVENUE		
If cash was received and previously recorded, the adjusting entry is		
Unearned Revenue (−L)	xx	
Revenue (+R, +SE)		xx
OR		
ACCRUED REVENUE		
If cash will be received, the adjusting entry is		
Receivable (+A)	xx	
Revenue (+R, +SE)		xx

When expense is incurred:		
DEFERRED EXPENSE		
If cash was paid and previously recorded, the adjusting entry is		
Expense (+E, −SE)	xx	
Prepaid Expense (−A)		xx
OR		
ACCRUED EXPENSE		
If cash will be paid, the adjusting entry is		
Expense (+E, −SE)	xx	
Payable (+L)		xx

Closing Entry

After recording expenses as debit and revenues as credit on the income statement, we can use a closing entry to transfer the income to retained earnings.

Answer is complete and correct.

TUNSTALL, INC.	
Income Statement	
For the Current Year Ended December 31	
Operating revenues	
Service revenue	$ 84,360
Operating expenses	
Wages expense	16,750
Supplies expense	260
Insurance expense	680
Depreciation expense	3,400
Remaining expenses (not detailed)	33,200
Total expenses	54,290
Operating income	30,070
Income tax expense	5,380
Net income	$ 24,690
Earnings per share	$ 4.94

Answer is complete and correct.

No	Transaction	General Journal	Debit	Credit
1	1	Service revenue	84,360	
		Wages expense		16,750
		Supplies expense		260
		Insurance expense		680
		Depreciation expense		3,400
		Remaining expenses (not detailed)		33,200
		Income tax expense		5,380
		Retained earnings		24,690