The Reporting Cycle

Part 4

Your goals for this “reporting cycle” chapter are to learn about:

- Preparation of financial statements.
- The accounting cycle and closing process.
- The nature of “optional” reversing entries.
- Classified balance sheets.
- The importance of business liquidity and the concept of an operating cycle.

18. Preparing Financial Statements

In the previous chapter, you learned all about adjustments that might be needed at the end of each accounting period. These adjustments were necessary to bring a company's books and records current in anticipation of calculating and reporting its income and financial position. However, Chapter 3 did not illustrate how those adjustments would be used to actually prepare the financial statements. This chapter will begin with that task.

18.1 An Illustration

To illustrate the process for preparing financial statements, let's look at some facts for England Tours Company. England began operation early in 20X3. In the process of preparing its financial statements for the year ending December 31, 20X3, England determined that the following adjusting entries were needed. The numbers are all "assumed" and you should not be concerned about that. But, if you are unclear as to why any one of these entries might be needed, you should definitely review the detailed discussion of adjusting entries from the previous chapter.

12-31-X3	Depreciation Expense		5,000	
	Accumulated Depreciation			5,000
	To record annual depreciation expense for equipment with a 9-year life ($45,000/9)			
12-31-X3	Salaries Expense		2,000	
	Salaries Payable			2,000
	To record accrued salaries due to employees at the end of December			
* 12-31-X3	Interest Expense		1,200	
	Interest Payable			1,200
	To record accrued interest on note payable ($20,000 X 6%)			
12-31-X3	Unearned Revenue		1,800	
	Revenue			1,800
	Year-end adjusting entry to reflect "earned" portion of tours sold in advance			

Below is a graphic showing England's trial balance before the above adjusting entries, and after the adjusting entries. If England had prepared its financial statements based only on the unadjusted trial balance, the reported information would be incomplete and incorrect. Instead, it is necessary to utilize the adjusted trial balance because it has been updated to reflect the year-end adjusting entries.

ENGLAND TOURS COMPANY
Trial Balance
December 31, 20X3

	Debits	Credits
Cash	$15,500	
Accounts receivable	4,500	
Equipment	45,000	
Accounts payable		$ 4,000
Unearned revenue		3,000
Notes payable		20,000
Capital stock		30,000
Revenue		31,000
Salaries expense	15,000	
Advertising expense	5,000	
Fuel expense	2,000	
Dividends	1,000	-
	$88,000	$88,000

RECORD ADJUSTING ENTRIES IN JOURNAL

12-31-X3	Depreciation Expense	5,000	
	Accumulated Depreciation		5,000
	To record annual depreciation expense for equipment with a 9-year life ($45,000/9)		
12-31-X3	Salaries Expense	2,000	
	Salaries Payable		2,000
	To record accrued salaries due to employees at the end of December		
12-31-X3	Interest Expense	1,200	
	Interest Payable		1,200
	To record accrued interest on note payable ($20,000 X 6%)		
12-31-X3	Unearned Revenue	1,800	
	Revenue		1,800
	Year-end adjusting entry to reflect "earned" portion of tours sold in advance		

POST ENTRIES TO THE LEDGER

ACCOUNT: Cash

Date	Description	Debit	Credit	Balance
Dec. 31, 20X3	Balance			$ 15,500

ACCOUNT: Accounts Receivable

Date	Description	Debit	Credit	Balance
Dec. 31, 20X3	Balance			$ 4,500

ACCOUNT: Equipment

Date	Description	Debit	Credit	Balance
Dec. 31, 20X3	Balance			$ 45,000

ACCOUNT: Accumulated Depreciation

Date	Description	Debit	Credit	Balance
Dec. 31, 20X3	Adjusting entry		$ 5,000	$ 5,000

ACCOUNT: Accounts Payable

Date	Description	Debit	Credit	Balance
Dec. 31, 20X3	Balance			$ 4,000

ACCOUNT: Unearned Revenue

Date	Description	Debit	Credit	Balance
Dec. 31, 20X3	Balance			$ 3,000
Dec. 31, 20X3	Adjusting entry	$ 1,800		$ 1,200

ACCOUNT: Salaries Payable

Date	Description	Debit	Credit	Balance
Dec. 31, 20X3	Adjusting entry		$ 2,000	$ 2,000

ACCOUNT: Interest Payable

Date	Description	Debit	Credit	Balance
Dec. 31, 20X3	Adjusting entry		$ 1,200	$ 1,200

ACCOUNT: Notes Payable

Date	Description	Debit	Credit	Balance
Dec. 31, 20X3	Balance			$ 20,000

ACCOUNT: Capital Stock

Date	Description	Debit	Credit	Balance
Dec. 31, 20X3	Balance			$ 30,000

ACCOUNT: Revenue

Date	Description	Debit	Credit	Balance
Dec. 31, 20X3	Balance			$ 31,000
Dec. 31, 20X3	Adjusting entry		$ 1,800	$ 32,800

ACCOUNT: Salaries Expense

Date	Description	Debit	Credit	Balance
Dec. 31, 20X3	Balance			$ 15,000
Dec. 31, 20X3	Adjusting entry	$ 2,000		$ 17,000

ACCOUNT: Advertising Expense

Date	Description	Debit	Credit	Balance
Dec. 31, 20X3	Balance			$ 5,000

ACCOUNT: Fuel Expense

Date	Description	Debit	Credit	Balance
Dec. 31, 20X3	Balance			$ 4,000

ACCOUNT: Depreciation Expense

Date	Description	Debit	Credit	Balance
Dec. 31, 20X3	Adjusting entry	$ 5,000		$ 5,000

ACCOUNT: Interest Expense

Date	Description	Debit	Credit	Balance
Dec. 31, 20X3	Adjusting entry	$ 1,200		$ 1,200

ACCOUNT: Dividends

Date	Description	Debit	Credit	Balance
Dec. 31, 20X3	Balance	$ 1,000		$ 1,000

PREPARE ADJUSTED TRIAL BALANCE FROM LEDGER

ENGLAND TOURS COMPANY
Adjusted Trial Balance
December 31, 20X3

	Debits	Credits
Cash	$15,500	
Accounts receivable	4,500	
Equipment	45,000	
Accumulated depreciation		$ 5,000
Accounts payable		4,000
Unearned revenue		1,200
Salaries payable		2,000
Interest payable		1,200
Notes payable		20,000
Capital stock		30,000
Revenue		32,800
Salaries expense	17,000	
Advertising expense	5,000	
Fuel expense	2,000	
Depreciation expense	5,000	
Interest expense	1,200	
Dividends	1,000	-
	$96,200	$96,200

18.2 Considering the Actual Process for Adjustments

Most of the time, a company will prepare its trial balance, analyze the trial balance for potential adjustments, and develop a list of necessary adjusting entries. Knowing what to adjust is not necessarily intuitive. It usually requires hands-on review by someone who is very knowledgeable about the business and accounting. As a practical matter, a company should not allow anyone and everyone to have access to the accounting system for purposes of entering year-end adjustments; too many errors and rogue entries will appear. Instead, a company will usually have a defined process where proposed entries are documented on a form (sometimes called a journal voucher). These forms are submitted to a chief accountant/controller who reviews and approves such proposed entries. The approved journal vouchers then serve as supporting documents to authorize data entry into the accounting system. The adjusting entries are entered in the journal, posted to the appropriate ledger accounts, and then the adjusted trial balance can be prepared from the up-to-date ledger.

18.3 Financial Statements

The adjusted trial balance is ordinarily sufficient to facilitate preparation of financial statements. You should take time to trace the amounts from England's adjusted trial balance to the financial statements that follow:

ENGLAND TOURS COMPANY
Income Statement
For the Year Ending December 31, 20X3

Revenues		
Tour services		$32,800
Expenses		
Salaries	$17,000	
Advertising	5,000	
Fuel	2,000	
Depreciation	5,000	
Interest	1,200	30,200
Net income		$ 2,600

ENGLAND TOURS COMPANY
Statement of Retained Earnings
For the Year Ending December 31, 20X3

Beginning retained earnings	$ -
Plus: Net income	2,600
	$2,600
Less: Dividends	1,000
Ending retained earnings	$1,600

ENGLAND TOURS COMPANY
Balance Sheet
December 31, 20X3

Assets		
Cash		$15,500
Accounts receivable		4,500
Equipment	$45,000	
Less: Accumulated depr.	(5,000)	40,000
Total assets		$60,000
Liabilities		
Accounts payable	$ 4,000	
Salaries payable	2,000	
Interest payable	1,200	
Notes payable	20,000	
Unearned revenue	1,200	
Total liabilities		$28,400
Stockholders' equity		
Capital stock	$30,000	
Retained earnings	1,600	
Total stockholders' equity		31,600
Total liabilities and equity		$60,000

18.4 Computerization

The financial statement preparation process is mostly mechanical, and easily automated. Once the adjusting entries have been prepared and entered, every accounting software package will race through the steps of processing the data to produce the financial statements. As such, you may be inclined to discount your need to understand how to move amounts from an adjusted trial balance into a set of financial statements. In some respects that is true, just as it is true that you do not need to know how to add and subtract if you own a calculator. Of course, you probably see the value of understanding addition and subtraction even if you use a calculator. In the same light, please consider that understanding the flow of transactions into financial statements is an essential foundation for furthering your knowledge of accounting.

18.5 A Worksheet Approach

Occasionally, one may desire to prepare financial statements that take into account necessary adjustments, but without actually updating journals and ledgers. Why? A manager may desire monthly financial reports even though the business may not formally prepare and book adjusting entries every month. A worksheet approach can be used for this purpose. Or, an auditor may use a worksheet to prepare financial statements that take into account recommended adjustments, before proposing that the actual journal/ledger be updated. The accounting department could be requested to prepare financial statements at any point in time; rather than break routine and book entries outside of the normal cycle, they might instead simply prepare financial statements via an informal worksheet.

The following illustrates a typical worksheet. The data and adjustments correspond to information previously presented for England. The first set of columns is the unadjusted trial balance. The next set of columns reveals the end-of-period adjustments. The information in the first two sets of columns is combined to generate the adjusted trial balance columns. The last three pairs of columns in the worksheet are the appropriate financial statement extensions of amounts from the adjusted trial balance columns. For example, Cash is an asset account with a debit balance, and is “appropriately” extended to the debit column of the balance sheet pair of columns. Likewise, Service Revenue is an income statement account with a credit balance; notice that it is extended to the income statement credit column. This extension of accounts should occur for every item in the adjusted trial balance. Look at the worksheet, and then consider the additional comments that follow.

After all adjusted trial balance amounts have been extended to the appropriate financial statement columns; the income statement columns are subtotaled. If credits exceed debits, the company has more revenues than expenses (e.g., $32,800 vs. $30,200 = $2,600 net income)). On the other hand, an excess of debits over credits would represent a net loss. To complete the worksheet, the amount of net income or loss is entered in the lower portion of the income statement columns in a manner which causes total debits to equal total credits. England Tours had a $2,600 net income, and a debit is needed to balance the income statement pair. An offsetting credit is entered in the lower portion of the retained earnings columns. This credit represents income for the year that must be added to retained earnings to complete the preparation of a formal statement of retained earnings. Within the retained earnings columns, the subtotal indicates that ending retained earnings is $1,600 (noted by the excess of credits ($2,600) over debits ($1,000)); this amount is debited in the retained earnings columns and credited in the balance sheet columns -- thereby bringing both sets of columns into final balance.

ENGLAND TOURS COMPANY
WORKSHEET TO PREPARE FINANCIAL STATEMENTS
DECEMBER 31, 20X3

	TRIAL BALANCE		ADJUSTMENTS		ADJUSTED TRIAL BALANCE		INCOME STATEMENT		STATEMENT OF RETAINED EARNINGS		BALANCE SHEET	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash	$ 15,500				$ 15,500						$ 15,500	
Accounts receivable	4,500				4,500						4,500	
Equipment	45,000				45,000						45,000	
Accounts payable		$ 4,000				$ 4,000						$ 4,000
Unearned revenue		3,000	$ 1,800			1,200						1,200
Notes payable		20,000				20,000						20,000
Capital stock		30,000				30,000						30,000
Service revenue		31,000		$ 1,800		32,800		$ 32,800				
Salaries expense	15,000		2,000		17,000		$ 17,000					
Advertising expense	5,000				5,000		5,000					
Fuel expense	2,000				2,000		2,000					
Dividends	1,000								$ 1,000			
Depreciation expense			5,000		5,000		5,000					
Accumulated Depreciation				5,000		5,000						5,000
Salaries payable				2,000		2,000						2,000
Interest expense			1,200		1,200		1,200					
Interest payable	-	-	-	1,200	-	1,200	-	-				1,200
	$ 88,000	$ 88,000	$ 10,000	$ 10,000	$ 96,200	$ 96,200	$ 30,200	$ 32,800				
Net income							2,600	-	-	$ 2,600		
							$ 32,800	$ 32,800	$ 1,000	$ 2,600		
Retained earnings									1,600	-	-	1,600
									$ 2,600	$ 2,600	$ 65,000	$ 65,000

18.6 An Additional Illustration

The illustration shown assumed England Tours was formed early in 20X3. As such, there was no beginning retained earnings balance. You may wonder how the worksheet would be influenced by a beginning retained earnings balance. If you were to look at England's 20X4 worksheet, the $1,600 ending retained earnings from 20X3 would carry over to become the beginning balance for 20X4.