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Adaptation to GAi:
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1

Theoretical Class n° 8

Chapter 4

Adjustments, Financial Statements and the Quality of Earnings

Objetivos de aprendizagem

- ✓ Explain the purpose of a trial balance (pages 201 - 202);
- ✓ Explain the purpose of adjustments and analyse the adjustments necessary at the end of the period to update balance sheet and income statement accounts (pages 203 - 212);
- ✓ Present the income statement, the balance sheet and the statement of cash flows (pages 213 - 217);
- ✓ Explain the closing process (pages 219 - 222).

Introduction

3

**Managers
prepare...**



**Financial
Statements**



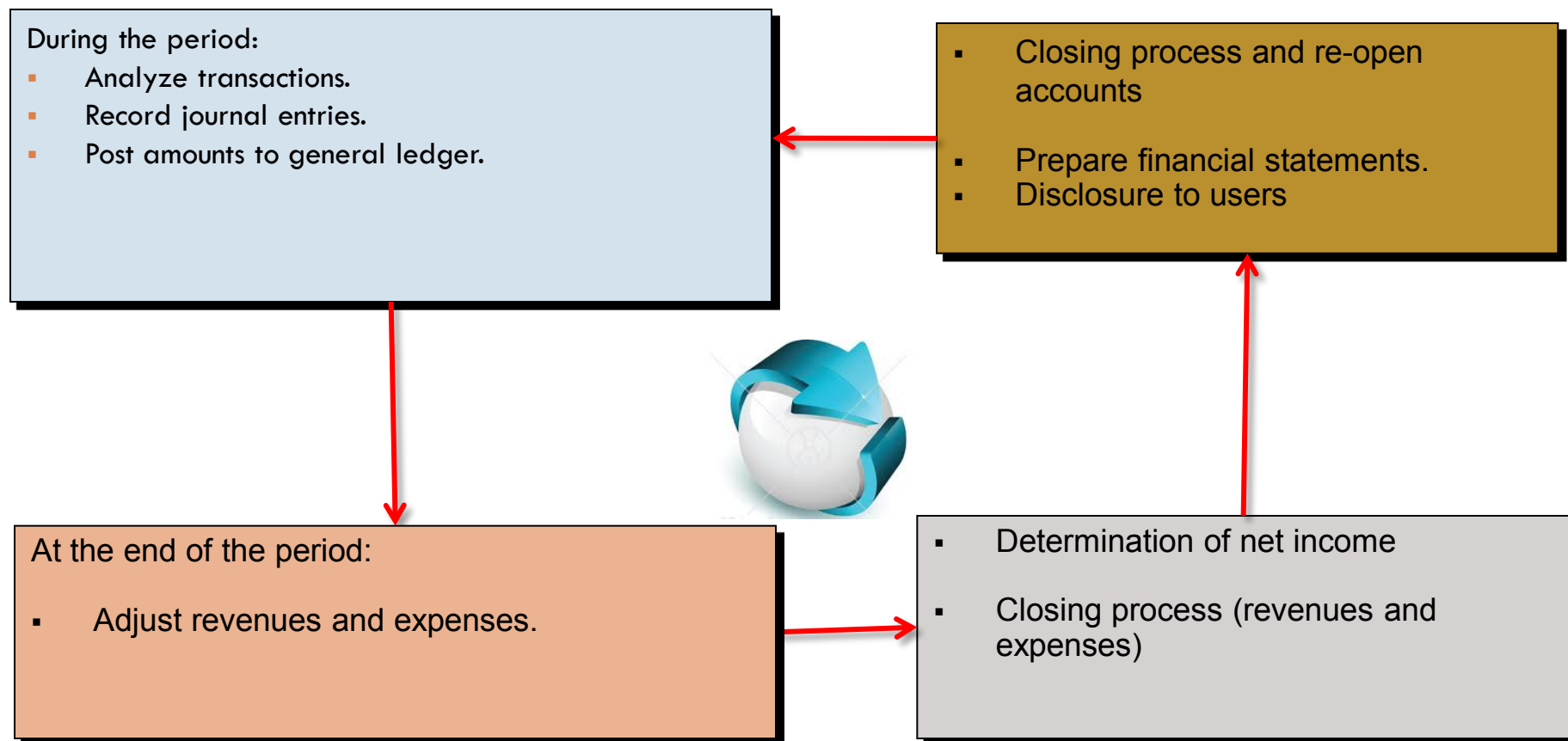
**Information with
Quality =
Relevance +
Reliability**



**... Useful
information for
investors,
creditors and
other parties**

Accounting cycle

4



Trial Balance

5

The transactions recorded during the accounting period are resumed in a trial balance, usually referred as “unadjusted trial balance”

- ✓ A column with a list of individual accounts names, usually in financial statements order;
- ✓ Followed by two columns with ending debit or credit balances;
- ✓ Total debit account balances should equal total credit account balances.

GreenBusiness – Unadjusted trial balance at January 31, N

Trial Balance

6



Income

Expenses

Account	Balance	
	Debit	Credit
Cash	500	
Cash deposits	32,500	
Other inventories	3,400	
Costumers	225,000	
Inventories	125,000	
Fixed Tangible Assets	204.750	
Suppliers		275,900
State		9,750
Loans		75,000
Other payable accounts		28,000
Capital		110,000
Reserves		14,500
Retained Earnings		20,000
Sales		915,000
Other revenues		1,000
Interest (financial) revenues		11,500
Cost of goods sold and consumed materials	575,000	
Supplies Expenses	166,000	
Salaries/Employees expenses	106,500	
Other expenses	22,000	
	1,460,650	1,460,650

Assets
Liab.
SE

We can do also two prior columns with the total debit and the total credit amounts

Purpose of adjustments

7

Revenues

Expenses

Revenues are recorded when earned and Expenses are recorded when incurred, regardless of the period in which the money is received or paid

Accrual basis

Because transactions occur over time, and over several accounting periods → at the end of each accounting period **ADJUSTMENTS** are required to get the revenues and expenses into the “correct” period.

Type of adjustments

8

Adjusting Entries that Increase Revenues:

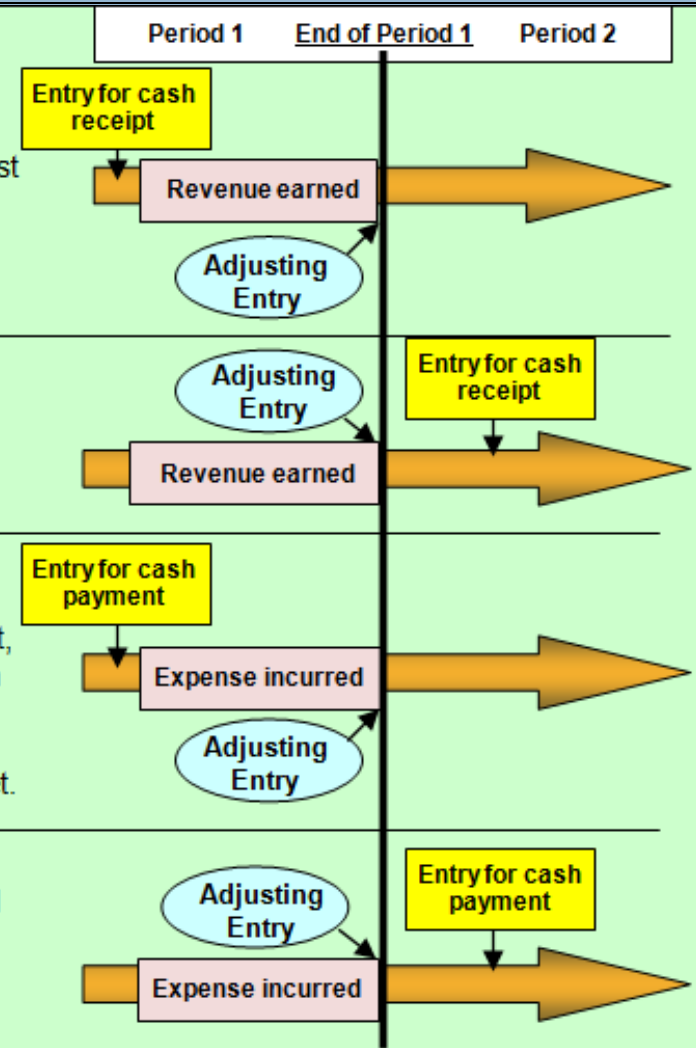
- **Deferred Revenues** – Previously recorded liabilities that were created when cash was received in advance, and that must be reduced for the amount of revenue actually earned during the period.

- **Accrued Revenues** – Revenues that are earned but not recorded because cash will be received after the services were performed or goods were 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 in advance and that must be reduced for the amount of expense actually incurred during the period through use of the asset.

- **Accrued Expenses** – Expenses that are incurred but were not recorded because cash will be paid after the goods or services were used.



Deferred revenues

9

In period N, GreenBusiness received a cash advance (1.500€) for the lease (rendered) of an equipment that will be incurred in January n+1.

Year N

Balance sheet N

Cash	+ 1.500	Deferals (deferred revenues)	+ 1.500
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D:	Cash	1.500
C:	Deferals (Deferred revenues)	1.500

Year N+1

Balance sheet N+1

Net income	+1.500
(Other revenues)	
Deferred revenues	- 1.500

D:	Deferred revenues	1.500
C:	Other revenues (rents)	1.500

Accrued revenues

10

GreenBusiness has a cash deposit (already recorded), that gives an annual interest revenue that will be received in the end of February N+1 amounting €240

Year N

10 months of interest earned in N
 $240 / 12 \times 10 = 200 \text{ €}$

Balance sheet N

Other accounts receivable (Accrued revenues) + 200	Net income + 200 (financial interest)
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Year N+1

2 months of interest earned in N+1
 $240 / 12 \times 2 = 40 \text{ €}$

Balance sheet N+1

Other accounts receivable (Accrued revenues) - 200	Net income + 40 (financial interest)
Cash + 240	

D:	Other accounts receivable (Accrued revenues)	200
C:	Financial income	200

D:	Cash	240
C:	Other accounts receivable (Accrued revenues)	200
C:	financial income	40

Deferred expenses

11

GreenBusiness pays at December 1, n, the insurance covering the total year N+1, amounting 1.200 €.

Year N			Year N+1		
Balance sheet N			Balance sheet N+1		
Deferals (Deferred expenses) + 1.200			Deferals (Deferred expenses) -1.200	Net income -1.200 (External Suppliers and Services)	
Cash - 1.200					
D: Deferals (Deferred Expenses) 1.200			D: External Supplies and services 1.200		
C: Cash 1.200			C: Deferals (Deferred Expenses) 1.200		

Accrued expenses

12

In period N GreenBusiness incurred in electricity and employees expenses amounting 500 € and 2.000 €, respectively, that will be paid in N+1.

Year N

Balance sheet N

Net income	- 2.500
(External Supplies and services; Employees expenses)	
Other accounts payable (Accrued expense)	+ 2.500

D:	Supplies and services; Employee expenses	2.500
C:	Other accounts payables (Accrued expenses)	2.500

Year N+1

Balance sheet N+1

Cash	- 2.500	Other accounts payable (Accrued expense)	- 2.500
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D:	Other accounts payables (Accrued expenses)	2.500
C:	Cash	2.500

Other adjustments – Depreciation expenses

13

Depreciation expenses

- ✓ Fixed assets are firstly recorded in the balance sheet by an amount that is its “cost of acquisition”
- ✓ This amount is then recognized in income on a systematic basis to the extent that the income will be generated by the asset (“matching”)(“*matching*”)
 - Depreciation expense
- ✓ Depreciation is estimated by the Manager based on the expected useful life of the asset and on its use



Depreciation expense

14

GreenBusiness record the depreciation expense for the fixed tangible assets, 10.000 €, in N

Year N			
Balance sheet N			
Fixed Tangible Assets	- 10.000	Net income	- 10.000
		(Depreciation expense)	

Depreciation expense decrease net income but has null impact on cash.

D:	Depreciation expense	10.000
C:	Fixed Tangible assets	10.000

Other adjustments– Income Taxes

15

GreenBusiness record as income tax for the year N the amount of 1.800 €. This value will be paid to the State in N+1.

Year N	
Balance sheet N	
Net income (Income tax)	- 1.800
State	+1.800

D:	Income tax (expense)	1.800
C:	State	1.800

Adjusted Trial Balance

16

Before preparing financial statements, we can do another trial balance after adjustment entries.



Adjusted Trial Balance

17

Account	Balance before adjustments		adjustments		Balance after adjustments	
	Debit	Credit	Debit	Credit	Debit	Credit
Cash	500		1,500	1,200	800	
Cash deposits	32,500				32,500	
Other inventories	3,400				3,400	
Costumers	225,000				225,000	
Other receivable accounts (Accrued revenues)			200		200	
Inventories	125,000				125,000	
Fixed Tangible Assets	204.750			10,000	194.750	
Suppliers		275,900				275,900
State		9,750		1,800		11,550
Loans		75,000				75,000
Other payable accounts (accrued expenses)		28,000		2,500		30,500
Deferred revenues and expenses			1,200	1,500	1,200	1,500
Capital		110,000				110,000
Reserves		14,500				14,500
Retained Earnings		20,000				20,000
Sales		915,000				915,000
Other revenues		1,000		200		1,200
Interest (financial) revenues		11,500				11,500
Cost of goods sold and consumed materials	575,000				575,000	
Supplies Expenses	166,000		500		166,500	
Salaries/Employees expenses	106,500		2,000		108,500	
Depreciation expense			10,000		10,000	
Other losses	22,000				22,000	
Income tax expense			1,800		1,800	
	1,460.650	1,460.650	17,200	17,200	1,477.850	1,477.850

Balance
Sheet

Income
Statement.

Income Statement

18



Income statement for the period ended at December, 31, N

Sales and Rendered services	915,000
Cost of goods sold and consumed materials	575,000
Supplies and external services	166,500
Employees expenses	108,500
depreciation expenses	10,000
Other revenues and gains	1,200
Other expenses and losses	22,000
Operating Income (EBIT)	34,200
Financial interest revenues	11,500
Financial interests expense	0
Income before Taxes (EBT)	45,700
Income Tax expense	1,800
Net income	43,900

Balance Sheet

19



Balance Sheet at December 31, N

ASSETS

Fixed Tangible assets	194,750
Intangibles	0
	<u>194,750</u>
Inventories	125,000
Costumers	225,000
Other receivable accounts (e.g., accrued revenues)	200
Deferred expenses	1,200
Cash deposits	32,500
Other deposits	3,400
Cash	800
	<u>388,100</u>
Total assets	582,850

SE and LIABILITIES

SE

Capital	110,000
Retained earnings and reserves	34,500
Net income	43,900
	<u>188,400</u>
Total SE	188,400

Liabilities

Loans	75,000
Suppliers	275,900
State	11,550
Other accounts payable (e.g., accrued expenses)	30,500
Deferred revenues	1,500
	<u>394,450</u>
Total Liabilities	394,450
Total SE and Liabilities	582,850

Statement of
Cash flows

Income
Statement

Closing the Books (closing process)

20

After preparing financial statements, all the trial balance accounts are balanced and closed

- ✓ Balance Sheet accounts (assets, liabilities and SE) → The ending balance is transferred and becomes the beginning (initial) balance for the next period
- ✓ Income statements accounts (revenues and expenses) → The ending balance is balanced (ready for new function in next year), and only the net income has a balance (profit or loss).



Closing and reopening accounts

21

Examples

Cash Deposits

Initial balance	45.000		
Entries during year	55.800	68.000	Entries during Year
		Debit Balance 32.800	
	100.800	100.800	
Initial Balance	32.800		

Supplies

	115.000	Initial balance
	155.800	316.700
		Credit balance 275.900
	431.700	431.700
		Initial Balance 275.900

Fecho e reabertura de contas

22

Examples

Cost of goods sold	
Entries during year	576.000
	1.000
	Debit balance
	575.000
Balance= 0	

Sales	
5.000	Entries during year
920.000	
Credit Balance	915.000
Balance= 0	

Net income	
575.000	915.000

Closing Trial Balanced

23

After closing the accounts we can make another trial balance: the balance sheet accounts have debit or credit balance; the income statement accounts have null balance



"Our books are balanced. 50% of our numbers are real and 50% are made up."

End of chapter 4