



ETHICS, FRAUD, & CORPORATE GOVERNANCE

As stated previously in this chapter, a company should disclose any facts that an intelligent person would consider necessary for the statements to be interpreted properly. Public companies are required to file annual reports with the Securities and Exchange Commission (SEC). These annual reports include a section labeled, "Management Discussion and Analysis" (MD&A). The SEC requires that companies include an MD&A in their annual reports because the financial statements and related notes may be inadequate for assessing the quality and sustainability of a company's earnings.

As an example of the importance of the MD&A, the SEC brought an enforcement action against Sony Corporation alleging inadequate disclosure in its MD&A. Although a Japanese corporation, Sony lists its stock on the New York Stock Exchange and is therefore subject to SEC oversight. Sony had reported only two industry segments in its annual report (electronics and entertainment). The entertainment segment included two separate units, Sony Music Entertainment and Sony Pictures Entertainment. The music group was profitable, whereas the pictures group was losing significant amounts of money. By combining its music and picture units as a single entertainment segment, Sony was able to conceal significant losses incurred by Sony Pictures. This decision was at odds

with both Sony's external auditor and with its U.S.-based financial staff.

Although Sony chose to report only two segments, it could have elaborated on the entertainment segment's performance in its MD&A by separately discussing the results of Sony Music and Sony Pictures. Sony did discuss Sony Pictures separately, but not in a manner necessary for an intelligent person to properly interpret the results of Sony Pictures. Sony's MD&A did not discuss the nature and extent of the losses incurred by Sony Pictures. Conversely, Sony's MD&A highlighted certain positive developments at Sony Pictures, including box office receipts, box office market share, and Academy Award nominations.

The SEC concluded that Sony's MD&A disclosures were inadequate. Sony consented to an SEC cease-and-desist order without either admitting or denying guilt. In essence, Sony did not agree that it did anything wrong, but it promised to never do what it did again. As part of its settlement, Sony also agreed to have its external auditor examine the MD&A for the following year and to publicly report the findings. This penalty was meaningful because an examination of the MD&A normally does not fall within the scope of an external audit.

Concluding Remarks

We have now completed the entire accounting cycle, the eight steps of which include:

1. *Journalize (record) transactions.* Enter all transactions in the journal, thus creating a chronological record of events.
2. *Post to ledger accounts.* Post debits and credits from the journal to the proper ledger accounts, thus creating a record classified by accounts.
3. *Prepare a trial balance.* Prove the equality of debits and credits in the ledger.
4. *Make end-of-period adjustments.* Make adjusting entries in the general journal and post to ledger accounts.
5. *Prepare an adjusted trial balance.* Prove again the equality of debits and credits in the ledger. (Note: These are the amounts used in the preparation of financial statements.)
6. *Prepare financial statements and appropriate disclosures.* An income statement shows the results of operation for the period. A statement of retained earnings shows changes in retained earnings during the period. A balance sheet shows the financial position of the business at the end of the period. Financial statements should be accompanied by notes disclosing facts necessary for the proper interpretation of those statements.
7. *Journalize and post the closing entries.* The closing entries "zero" the revenue, expense, and dividends accounts, making them ready for recording the events of the next accounting period. These entries also bring the balance in the Retained Earnings account up-to-date.
8. *Prepare an after-closing trial balance.* This step ensures that the ledger remains in balance after the posting of the closing entries.

SUPPLEMENTAL TOPIC

THE WORKSHEET

A **worksheet** illustrates in one place the relationships among the unadjusted trial balance, proposed adjusting entries, and financial statements. A worksheet is prepared at the end of the period, but before the adjusting entries are formally recorded in the accounting records. It is not a formal step in the accounting cycle. Rather, it is a tool used by accountants to work out the details of the proposed end-of-period adjustments. It also provides them with a preview of how the financial statements will look.

You can see a worksheet for Overnight Auto Service at December 31, 2018, in Exhibit 5-13.

LO5-8

LEARNING OBJECTIVE
Prepare a worksheet and explain its uses.

ISN'T THIS REALLY A SPREADSHEET?

Yes. The term *worksheet* is a holdover from the days when these schedules were prepared manually on large sheets of columnar paper. Today, most worksheets are prepared using a spreadsheet software or with **general ledger software**.

Since the worksheet is simply a tool used by accountants, it often isn't printed out in hard copy—it may exist only on a computer screen. But the concept remains the same; the worksheet displays in one place the unadjusted account balances, proposed adjusting entries, and financial statements as they will appear if the proposed adjustments are made.

HOW IS A WORKSHEET USED?

A worksheet serves several purposes. It allows accountants to see the effects of adjusting entries without actually entering these adjustments in the accounting records. This makes it relatively easy for them to correct errors or make changes in estimated amounts. It also enables accountants and management to preview the financial statements before the final drafts are developed. Once the worksheet is complete, it serves as the source for recording adjusting and closing entries in the accounting records and for preparing financial statements.

Another important use of the worksheet is in the preparation of interim financial statements. Interim statements are financial statements developed at various points during the fiscal year. Most companies close their accounts only once each year. Yet they often need to develop quarterly or monthly financial statements. Through the use of a worksheet, they can develop these interim statements without having to formally adjust and close their accounts.

THE MECHANICS: HOW IT'S DONE

Whether done manually or on a computer, the preparation of a worksheet involves five basic steps. We begin by describing these steps as if the worksheet were being prepared manually. Afterward, we explain how virtually all of the mechanical steps can be performed automatically by a computer.

1. *Enter the ledger account balances in the Trial Balance columns.* The worksheet begins with an unadjusted trial balance. A few lines should be left blank immediately below the last balance sheet account. It is often necessary to add a few more accounts during the adjusting process. Additional income statement accounts also may be necessary. In our illustration, the unadjusted trial balance appears in blue.
2. *Enter the adjustments in the Adjustments columns.* This step is the most important: Enter the appropriate end-of-period adjustments in the Adjustments columns. In our illustration, these adjustments appear in red. Notice that each adjustment includes both debit and credit entries, which are linked together by the small key letters appearing to the left of the dollar amount. Thus, adjusting

entry *a* consists of a \$600 debit to Supplies Expense and a \$600 credit to Shop Supplies. Because the individual adjusting entries include equal debit and credit amounts, the totals of the debit and credit Adjustments columns should be equal.

Sometimes the adjustments require adding accounts to the original trial balance. (The four ledger account titles printed in red were added during the adjusting process.)

3. *Prepare an adjusted trial balance.* The balances in the original trial balance (blue) are adjusted for the debit or credit amounts in the Adjustments columns (red). The adjusted trial balance is totaled to determine that the accounts remain in balance.

At this point, the worksheet is almost complete. We have emphasized that financial statements are prepared directly from the adjusted trial balance. Thus we have only to arrange these accounts into the format of financial statements.

4. *Extend the adjusted trial balance amounts into the appropriate financial statement columns.* The balance sheet accounts—assets, liabilities, and owners' equity—are extended into the Balance Sheet columns; income statement amounts, into the Income Statement columns. (The Balance Sheet and Income Statement captions in the original trial balance should simplify this procedure. Notice each amount is extended to only one column. Also, the account retains the same debit or credit balance as shown in the adjusted trial balance.)

5. *Total the financial statement columns; determine and record net income or net loss.* The final step in preparing the worksheet consists of totaling the Income Statement and Balance Sheet columns and then bringing each set of columns into balance. These tasks are performed on the bottom three lines of the worksheet. In our illustration, the amounts involved in this final step are shown in black.

When the Income Statement and Balance Sheet columns are first totaled, their respective debit and credit columns will *not* be equal. But each set of columns should be out of balance by the same amount—and that amount should be the amount of net income or net loss for the period.

Let us briefly explain why both sets of columns initially are out of balance by this amount. First consider the Income Statement columns. The Credit column contains the revenue accounts, and the Debit column, the expense accounts. The difference, therefore, represents the net income (net loss) for the period.

Now consider the Balance Sheet columns. All of the balance sheet amounts are shown at up-to-date amounts except for the Retained Earnings account, which still contains the balance from the beginning of the period. To bring the Retained Earnings account up-to-date, we must add net income and subtract any dividends. The dividends already appear in the Balance Sheet Debit column. So what's the only thing missing? The net income (or net loss) for the period.

To bring both sets of columns into balance, we enter the net income (or net loss) on the next line. The same amount will appear in both the Income Statement columns and the Balance Sheet columns. But in one set of columns it appears as a debit, and in the other, it appears as a credit.³ After this amount is entered, each set of columns should balance.

Computers Do the Pencil-Pushing When a worksheet is prepared by computer, accountants perform only one of the steps listed above—entering the adjustments. The computer automatically lists the ledger accounts in the form of a trial balance. After the accountant has entered the adjustments, it automatically computes the adjusted account balances and completes the worksheet. (Once the adjusted balances are determined, completing the worksheet involves nothing more than putting these amounts in the appropriate column and determining the column totals.)

³ To bring the Income Statement columns into balance, net income is entered in the Debit column. This is because the Credit column (revenue) exceeds the Debit column (expenses). But in the balance sheet, net income is an element of owners' equity, which is represented by a credit. In the event of a net loss, this situation reverses.

OVERNIGHT AUTO SERVICE
WORKSHEET
FOR THE YEAR ENDED DECEMBER 31, 2018

	Trial Balance		Adjustments*		Adjusted Trial Balance		Income Statement		Balance Sheet	
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
Balance sheet accounts:										
Cash	18,592				18,592				18,592	
Accounts Receivable	6,500		(h) 750		7,250				7,250	
Shop Supplies	1,800			(a) 600	1,200				1,200	
Unexpired Insurance	4,500			(b) 1,500	3,000				3,000	
Tools and Equipment	12,000				12,000				12,000	
Accumulated Depreciation: Tools and Equipment		2,000		(d) 200		2,200				2,200
Building	36,000				36,000				36,000	
Accumulated Depreciation: Building		1,500		(c) 150		1,650				1,650
Land	52,000				52,000				52,000	
Notes Payable		4,000				4,000				4,000
Accounts Payable		2,690				2,690				2,690
Income Taxes Payable		1,560		(f) 4,020		5,580				5,580
Unearned Rent Revenue		9,000	(e) 3,000			6,000				6,000
Capital Stock		80,000				80,000				80,000
Retained Earnings		0				0				0
Dividends	14,000				14,000				14,000	
Wages Payable				(f) 1,950		1,950				1,950
Interest Payable				(g) 30		30				30
Income statement accounts:										
Repair Service Revenue		171,250		(h) 750		172,000		172,000		
Advertising Expense	3,900				3,900		3,900			
Wages Expense	56,800		(f) 1,950		58,750		58,750			
Supplies Expense	6,900		(a) 600		7,500		7,500			
Depreciation Expense: Building	1,500		(c) 150		1,650		1,650			
Depreciation Expense: Tools and Equipment	2,000		(d) 200		2,200		2,200			
Utilities Expense	19,400				19,400		19,400			
Insurance Expense	13,500		(b) 1,500		15,000		15,000			
Income Taxes Expense	22,608		(i) 4,020		26,628		26,628			
Rent Revenue Earned				(e) 3,000		3,000		3,000		
Interest Expense			(g) 30		30		30			
Totals	272,000	272,000	12,200	12,200	279,100	279,100	135,058	175,000	144,042	104,100
Net income							39,942		39,942	
Totals							175,000	175,000	144,042	144,042

*Adjustments:

- (a) Shop supplies used in December.
- (b) Portion of insurance cost expiring in December.
- (c) Depreciation on building for December.
- (d) Depreciation of tools and equipment for December.
- (e) Earned one-third of rent revenue collected in advance from Harbor Cab.
- (f) Unpaid wages owed to employees at December 31.
- (g) Interest payable accrued during December.
- (h) Repair service revenue earned in December but not yet billed.
- (i) Income taxes expense for December.