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MUF0022 FINANCIAL ACCOUNTING

Adjustments for Accruals

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3.1 Learning Outcomes

Explain why adjustments are needed for accruals (expenses/ revenues)
Explain why the Liability approach is applied
Apply relevant Accounting Principles and Qualitative Characteristics
Analyse and evaluate the impact of adjustments on Financial Statements

3.2 Key Terms & Concepts

- Record the following adjustments in the general journal, general ledger and subsidiary records:
- Accrued Expense
- Accrued Revenue
- Impact of adjustments on Financial Statements
- Relevant application of Accounting Principles and Qualitative Characteristics

Accruals of Expenses

In our earlier work we have considered the possibility of paying for expenses in advance. Prepaid expenses are paid before they are consumed, but it is also likely that some expenses will be paid after they are consumed. For example, at ***balance day*** there may be wages ***owing*** to employees for work that has already been done, or electricity that has been used in order to earn revenue but not yet paid for. Such amounts have already been incurred or used to generate revenue in the current Reporting Period.

So these amounts of ***accrued expenses*** must be added to the expense amount for the current Reporting period. Recognising the amount owing should will also identify an amount to be recorded as a liability. The amount still owing for an expense that has already been consumed is called an ***accrued expense***. An expense amount used but not paid as at balance day is an accrued expense.

We will identify the expense specifically as Accrued Wages (where the amount owing is for employees' wages) or Accrued Electricity (where the amount owing is for Electricity used during the period but not yet paid for).

Consider the example of a business that uses a weekly cleaning service which costs $325 per week. The payment for cleaning services is paid at the end of each month for the total amount of $1 300. The business prepares its reports quarterly at the end of March, June, September and December.

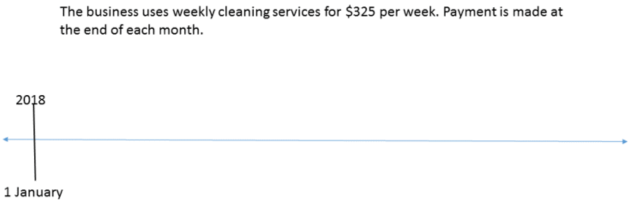
The amount for cleaning services for March has not been paid at the time of reporting on 31 March 2018.

Think about the following questions:

- When is balance day for the first quarter reporting period?
- How much has been paid for cleaning services for this quarter?
- How much has been incurred but not paid for cleanings services for this quarter?
- How would we record this amount owing?
- Why does recording the Accrued Cleaning Services create a liability account?

On the 31 March 2018 the business has already incurred and paid for January and February Cleaning Services Expense of $2 600. The business has also used but not paid for March of $1 300. The amount owing for the Cleaning Services would be recorded like this in the General Ledger:

- DR: Cleaning Services (Expense)
- CR: Accrued Cleaning Services (Liability)



At balance day, what will be the impact on the Financial Statements that are then prepared.

How will accrued expenses be reported in the:

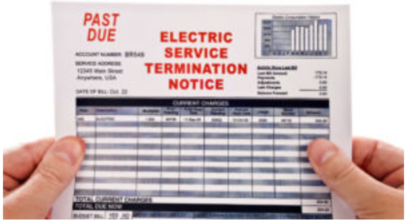
1. Income Statement?
2. Cash Flow Statement?
3. Balance Sheet?

The ***Income Statement*** matches revenue earned with expenses incurred for a given period of time. Therefore, if the amount of the accrued expense that has been incurred/consumed will be added to the expense account and included under the heading of 'Other Expenses'.

The ***Cash Flow Statement*** will not reflect any of the accrued calculations because there has not been any cash flow from this recording. Only the amount already paid (if any) during the reporting period will be shown as an outflow in Operating Activities.

The ***Balance Sheet*** will show the accrued expense account that has not yet been paid, and that remains in the as a Current Liability.

As with each adjusting entry that we record, it is important to consider how the recording and reporting reflects the Accounting Principles and Qualitative Characteristics of our profession. How do the Accounting Principles of Reporting Period and Conservatism apply to the recording and reporting of Accrued Expenses? What is your understanding of the Qualitative Characteristic of Relevance in these circumstances?



Accruals of Revenue

In some cases the business will have earned revenues but this has still not been recognised at balance day due to timing of events. For example, interest on a term deposit may have been earned each month, but is not due to be received until the end of the deposit period which might be another three months away. Other items such as royalties and commissions may only be received after they have been earned. Because this amount has been earned in the current Reporting Period, it must be recognised as revenue. The amount owing should also be recorded as a ***current asset***, as some time in the future, the cash will be received. The amount owed to us for revenue we have already earned is called ***accrued revenue***.

On 1 August 2017, Kate's Cafe invested $10 000 in a term deposit, earning interest at 9% per annum. Interest is received on 31 January and 31 July each year. The firm prepares its reports on 30 June each year.

On 31 January 2018, the firm would receive $450 interest revenue for the first six months of the term deposit. The next instalment of interest will not be received until 31 July 2018. However, the business will prepare its reports on 30 June 2018.

Consider the following:

- When is balance day for the business?

- How much interest has been received by the business from its term deposit?
- How much has been interest revenue has been earned but not yet received as at balance day?
- How would we record this amount of revenue owing to the business?
- Why does recording the Accrued Interest create a Current Asset account?

By 30 June 2018 the business has already earned and received Interest Revenue of $450. The business has also earned but not received the 5 months of interest to 30 June of $375. The amount owing to the business as Interest Revenue would be recorded like this in the General Ledger:

- DR: Accrued Interest Revenue (Asset)
- CR: Interest Revenue (Revenue)

At balance day, what will be the impact on the Financial Statements that are then prepared.

How will accrued expenses be reported in the:

1. Income Statement?
2. Cash Flow Statement?
3. Balance Sheet?

The ***Income Statement*** matches revenue earned with expenses incurred for a given period of time. Therefore, if the amount of the accrued revenue that has been earned is added to the revenue account and included under the heading of 'Other Revenue'.

The ***Cash Flow Statement*** will not reflect any of the accrued calculations because there has not been any cash flow from this recording. Only the amount already received (if any) during the reporting period will be shown as an inflow in Investing Activities.

The ***Balance Sheet*** will show the accrued revenue account that has not yet been received, and that remains as a Current Asset.

Once again, how does the Qualitative Characteristic of Relevance apply to the reporting of this accrued revenue? What is the relationship between recording this adjusting entry and the Accounting Principles of Conservatism and Reporting Period?

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