Accounting in practice

1. Adjusting entries: accruals and deferrals

Adjusting entries and its characteristics

The need for adjusting entries:

To sync up cash flows with revenue and expenses in accordance with the recognition and matching principles, adjustments must be made to the income and financial position statements.

Characteristics of adjusting entries:

- Every adjusting entry involves the recognition of revenue or expenses – with a corresponding change in assets or liabilities (so that profit can be reflected as a change in equity)
- Every adjustment affects both income and financial position statements

Converting assets to expenses (adjusting for pre-paid expenses)

When a business makes an expenditure that will benefit more than one accounting period, the amount is usually debited to an asset account – then at the end of each period benefiting from this expenditure an adjusting entry is made to transfer a portion of the cost from the asset to expense account. Prepaid expenses are systematically matched with revenues in two ways:

- Credit cash, debit (creation) of asset (receivables, consumables) → expense and credit of asset
- Credit cash, debit (creation) of asset (PPE, non-consumables) → debit depreciation expense, credit accumulated depreciation (contra-asset, because it has a credit balance)
  - **Book value of asset = asset cost – accumulated depreciation**

Concept of depreciation

- Depreciable assets are physical objects that wear out or become obsolete and are not physically consumed
- Depreciation is the systematic allocation of the cost of a depreciable asset to expense over the asset's useful life
- Rationale lies in the matching principle – to offset a reasonable portion of the asset's cost against revenue in each period of the useful life
- Deprecation model is only an estimate
- A non-cash expense which often represents the largest difference between profit and cash flow

Converting liabilities to revenue (adjusting for pre-paid revenue)

For accounting purposes, amounts collected in advance do not represent revenue because they have not yet been earned. Pre-paid revenue is systematically recognised by:

- Debit cash, credit (creation of) unearned revenue account (liability – owed good or service)

Accruing unpaid expenses (delaying cash payment of expenses)

This type of adjusting entry recognises expenses that will be paid in cash in future. These expenses are said to 'accrue' – grow – over time. These unpaid (but incurred from the generation of revenue) expenses are recognised by:

- Debit expense, credit payables (liabilities)
- Upon payment, credit cash (asset), debit payables (liabilities)

Accruing uncollected revenue (delaying cash collection of earned revenue)

A business may earn revenue during the current accounting period but not collect the cash until a future accounting period. To sync the financial position and income statements, this is recognised as:

- Credit revenue, debit receivables (asset)
- Upon collection of payment, debit cash (asset), credit receivables (asset)

Materiality and adjusting entries

Materiality refers to the relative importance of an item of event. If knowledge of the item or event might reasonably influence the economic decisions of the users of financial statements, it is considered material. It is a matter of professional judgement.

It can help to simplify accounting processes, such as ignoring unrecorded expenses or revenue (if they are insignificant), charging to expenses with cash flows (rather than accruing – e.g. phone bills), charging expenses directly rather than creating a depreciable asset (e.g. office supplies).

Changes after adjustments to sync financial position and income statements

Adjustments for	Income Statement			Statement of financial position		
	Revenue	Expense	Profit	Assets	Liabilities	Equity
Pre-paid expense	-	Increase	Decrease	Decrease	-	Decrease
Pre-paid revenue	Increase	-	Increase	-	Decrease	Increase
Delaying expense payment	-	Increase	Decrease	-	Increase	Decrease
Delaying collection of revenue	Increase	-	Increase	Increase	-	Increase

2. Reporting financial results

Preparing financial statements

Publicly owned companies – those with shares listed on a stock exchange – have obligations to release annual and quarterly information to their shareholders and public. To prepare these reports, the income statement is prepared first because it determines the amount of profit to be reported in the statement of changes in equity.

Income, changes in equity and financial position statements are all systematically linked.

Income statement (profit) → Statement of changes in equity (retained earnings – dividends) → Financial position (total equity)

Income statement	Statement of changes in equity	Statement of retained earnings	Statement of financial position
Records revenue, expenses and profits. But has limitations due to assumptions: 1. Expenses are influenced by estimates, such as depreciation	Equity includes share capital (total value of shares issues), retained earnings (portion of shareholder's equity created by earning profit and retaining those resources) and other equity balances. Share capital at beginning + new shares issues – repurchase of shares = Share capital at end Retained earnings at beginning + profit – dividends = retained earnings at end Equity = share capital + retained earnings		

<table>
<tr><th>Income statement</th><th>Statement of changes in equity</th></tr>
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1. Expenses are influenced by estimates, such as depreciation</td><td>Equity includes share capital (total value of shares issues), retained earnings (portion of shareholder’s equity created by earning profit and retaining those resources) and other equity balances.

Share capital at beginning + new shares issues – repurchase of shares = Share capital at end

Retained earnings at beginning + profit – dividends = retained earnings at end

Equity = share capital + retained earnings</td></tr>
<tr><th>Statement of financial position</th><th>Notes that accompany financial statements</th></tr>
<tr><td>Records assets, liabilities and equity.

<u>Financial position subtotals</u>
Many companies group together items subtotals into distinct categories. E.g. current assets, current liabilities

These are useful for evaluating a company.</td><td>To the users of financial statements, adequate disclosure is important. As a general rule, a company should disclose any facts (through the notes) that an informed user would consider necessary for the statements to be interpreted properly. These include:

• Lawsuits
• Scheduled closings
• Significant events
• Unusual transactions, conflicts of interest
• …</td></tr>
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Evaluating the business

<u>Measures of profitability</u>

$$\text{Profit percentage} = \frac{\text{Profit}}{\text{Total revenue}}$$

$$\text{Return on equity} = \frac{\text{Profit}}{\text{Average shareholder equity}} = \frac{\text{Profit}}{(\text{Beginning} + \text{End})/2}$$

<u>Measures of liquidity</u>

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

$$\text{Working capital}\ \ \text{current assets} - \text{current liabilities}$$