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CHAPTER 4

ACCRUAL ACCOUNTING CONCEPTS

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Learning Objectives

- Explain when revenues and expenses are recognized.
- Prepare adjusting entries for prepayments and accruals.
- Prepare the adjusted trial balance.
- Prepare closing entries and a post-closing trial balance.



Timing Issues

- Accounting divides the economic life of a business into artificial time periods (one month, one quarter, or one year).
- Many accounting transactions affect more than one time period.
- Need some standards that define when we should recognize revenues and expenses.



Timing Issues

Revenue recognition

- Revenue is recognized (recorded) when there is an increase in future economic benefits arising from an increase in an asset or a decrease in a liability, due to ordinary activities.

- Criteria for recognition:
 1. the sales or performance effort is substantially complete,
 2. the amount is determinable (measurable),
 3. collection is reasonably assured.



Timing Issues

Expense recognition

- Expenses are recognized when:
 - there is a decrease in future economic benefits due to an ordinary activity:
 - a decrease in an asset or
 - an increase in a liability
 - this change can be measured reliably.

- often coincide with revenue recognition (matching), but not always.



Timing Issues

Accrual basis accounting

- transactions are recorded in the periods in which the events occur.
- satisfy the requirements of ASPE and IFRS.
- considered as the most appropriate method of financial reporting

Cash basis accounting

- events are recognized in the period that cash is paid or received.
- does not satisfy the requirements of ASPE and IFRS.
- can lead to misleading financial statements.

Adjusting Entries

- The trial balance may not contain complete and up-to-date data:
 - Some events are not recorded daily.
 - Some costs are not recorded during the accounting period.
 - Some items may be unrecorded.

- Record adjusting entries to update accounts at the end of the accounting period.



Adjusting Entries

- Adjusting entries are required every time financial statements are prepared.
- Each account in the trial balance needs to be analysed to see if it is complete and up to date.
- Preparing adjusting entries is often a long and detailed process:
 - count remaining supplies
 - prepare supporting schedules of insurance policies, rental agreements.

Adjusting Entries

Types of adjusting entries:

1. prepayments

- prepaid expenses (prepayments paid)
- unearned revenue (prepayments received)

2. accruals

- accrued expenses (incurred but not yet paid in cash or recorded)
- accrued revenues (earned but not yet received in cash or recorded)

Adjusting Entries

I. Prepayments

1. Prepaid expenses

- are paid for in cash before they are used
- expire with the passage of time (insurance, depreciation) or through use (supplies).
- it is not practical to record this expiration on a daily basis.

Adjusting entry:

- Record the expense that applies to the current period (debit an expense account)
and
- Reduce the asset account that was originally recorded (credit an asset (prepaid) account)

Example:

A company adjusts its accounts annually. The following information is available for the year ended December 31, 2012:

- Purchased a one-year insurance policy on June 1, for \$1,800 cash.
- Paid \$6,500 on August 31 for five months' rent in advance.

1. For each of the above transactions, prepare the journal entry to record the initial transaction.
2. For each of the above transactions, prepare the adjusting journal entry that is required on December 31, 2012.

Adjusting Entries

Depreciation

- Depreciation is the process of allocating the acquisition cost of a long-lived or non current asset to expense over its useful life.
- It is not a valuation concept.
- Adjusting entry for depreciation:
 Dr. Depreciation expense
 Cr. Accumulated depreciation

Straight line method of depreciation:

Depreciation= (cost-residual value)/estimated useful life.

Adjusting Entries

Example

A company purchased a truck for 58,000. The truck has a useful life of 5 years and a residual value of 8,000. Calculate the depreciation expense per year.

Adjusting Entries

2. Unearned revenue

- Cash that has been received before revenue is earned.
- Unearned revenues are later earned when the service is provided to the customer.
- Not practical to make daily journal entries as the revenue is earned.

Adjusting Entries

Adjusting entry:

- Reduce the liability account where the unearned revenue was originally recorded (debit a liability account)

and

- Record the revenue earned in the period (credit a revenue account)

Example:

A company adjusts its accounts annually. The following information is available for the year ended December 31, 2012:

On September 14, received \$3,600 cash from a corporation to sponsor a game each month for the most improved students. The amount is to be distributed evenly over nine times of playing the game, once on the first Friday of each month starting in October.

1. prepare the journal entry to record the initial transaction.
2. prepare the adjusting journal entry that is required on December 31, 2012.

Adjusting Entries

II. Adjusting entries for accruals

- are required in order to record revenues earned or expenses incurred in the current accounting period.

- Two types:
 - Accrued revenues
 - Accrued expenses

Adjusting Entries

1. Accrued revenues

- revenues that have been earned but not yet received on cash or recorded.
 - May accumulate with the passing of time (e.g., interest revenue).
 - May result from services that have not yet billed or collected (e.g, fees).

Adjusting entry:

- Increase an asset account (debit an asset account)
- Increase a revenue account (credit a revenue account).

Adjusting Entries

Until the adjustment is made:

- Assets and revenues are understated
- Profit and shareholders equity are understated.

Example:

A company has earned \$500 in interest revenue, which has not been collected in cash or recorded at the financial statement date.

Adjusting entry:

Adjusting Entries

2. Accrued expenses

- expenses incurred but not yet paid or recorded at the statement date.

- Examples:
 - interest,
 - rent,
 - salaries,
 - property tax,
 - income taxes.

- An accrued expense on the books of one company is an accrued revenue to another company.

Adjusting Entries

- Until the adjustment is made:
 - Liabilities and expenses are understated
 - Profit and shareholders' equity are overstated.

- *Adjusting entry:*
 - Increase an expense account (Debit an expense account)
 - and
 - Increase a liability account (Credit a liability account).

Adjusting Entries

Example:

On November 1, a company borrows \$24,000 at 3% interest for six months. The principal and all interest are due on May 1. The company prepares its financial statements at December 31.

Adjusting entry

Adjusting Entries

	Type of Adjustment	Reason for Adjustment	Accounts before Adjustment	Adjusting Entry
Prepayments	Prepaid expenses	Prepaid expenses, originally recorded in asset accounts, have been used.	Assets overstated; expenses understated	Dr. Expense Cr. Asset
	Unearned revenues	Unearned revenues, initially recorded in liability accounts, have been earned.	Liabilities overstated; revenues understated	Dr. Liability Cr. Revenue
Accruals	Accrued revenues	Revenues have been earned but not yet received in cash or recorded.	Assets understated; revenues understated	Dr. Asset Cr. Revenue
	Accrued expenses	Expenses have been incurred but not yet paid or recorded.	Expenses understated; liabilities understated	Dr. Expense Cr. Liability

Adjusted trial balance and financial statements

After journalizing adjusting entries:

- Post adjusting entries.
- Prepare the adjusted trial balance.
- Prepare the financial statements from the adjusted trial balance.

Closing the books

- Temporary/permanent accounts:
 - Revenue, expense and dividends accounts are considered to be temporary accounts.
 - Statement of financial position accounts are considered to be permanent accounts.

- At the end of each period the temporary account balances are transferred to the permanent shareholders' equity account Retained Earnings through the preparation of closing entries.

Closing the books

The closing process:

1. Close revenue accounts:
 - debit each individual revenue account
 - credit Income summary for total revenues.

2. Close expense accounts:
 - debit Income summary for total expenses
 - credit each individual expense account.

3. Close income summary account:
 - debit (credit) Income summary
 - credit (debit) retained earnings.

4. Close the dividend account:
 - debit retained earnings
 - credit dividends.

Closing the books

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Salaries Expense		
4,000	(2) CE	7,200
3,200		
0		

Supplies Expense		
1,500	(2) CE	1,500
0		

Rent Expense		
900	(2) CE	900
0		

Depreciation Expense		
83	(2) CE	83
0		

Insurance Expense		
50	(2) CE	50
0		

Income Summary		
(2) CE	9,958	(1) CE 10,600
(3) CE	642	
		0

Retained Earnings		
(4) CE	500	0
	(3) CE	642
	Bal.	142

Dividends		
500	(4) CE	500
0		

Interest Expense		
25	(2) CE	25
0		

Service Revenue		
(1) CE	10,600	10,000
		400
		200
		0

Retained Earnings is a permanent account; the other accounts in this illustration are temporary accounts.

Closing the books

Other Comprehensive Income (OCI) and Accumulated OCI

- Items included in OCI are:
 - gains and losses relating to certain foreign transactions.
 - certain adjustments made to reflect some assets and liabilities at fair value.

- Comprehensive income = profit + OCI.

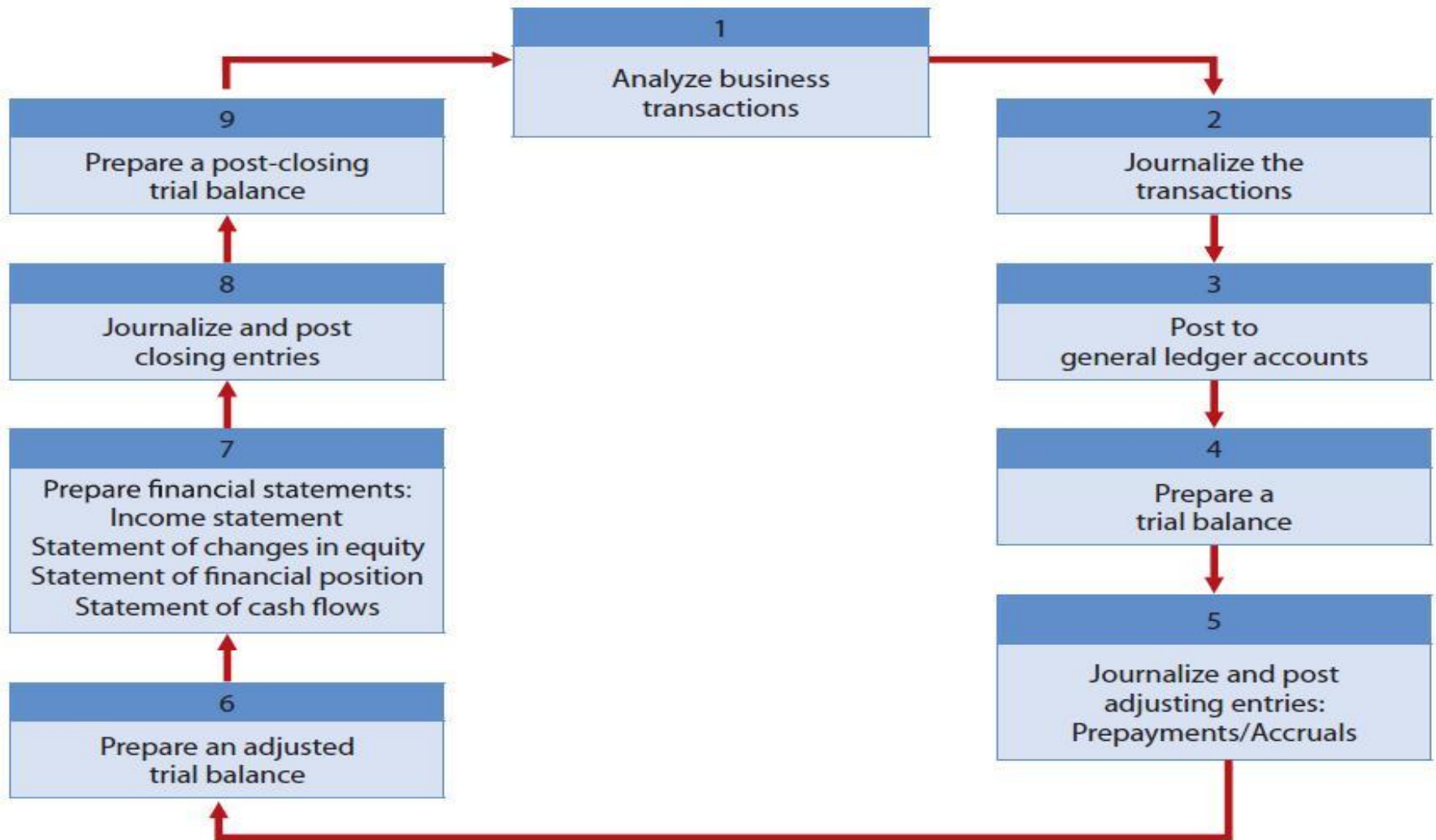
- OCI is closed out to various equity accounts.

Closing the books

Post closing trial balance

- Lists all permanent accounts and their balances after closing entries are journalized and posted.
- Proves the equality of total debit balances and total credit balances after the closing entries have been made.

Summary of the Accounting Cycle



Comparing IFRS and ASPE

comparing IFRS and ASPE

Key Differences	International Financial Reporting Standards (IFRS)	Accounting Standards for Private Enterprises (ASPE)
Frequency of adjusting entries	Public companies must release quarterly financial statements so adjusting entries have to be made at least quarterly, although many will record adjusting entries every month.	Private companies usually release financial statements to their banker, and shareholder(s), along with certain financial information to the Canada Revenue Agency on an annual basis so adjusting entries may be done only at year end, although many will record adjusting entries more frequently.
Terminology	The term <i>depreciation</i> refers to the allocation of the cost of depreciable tangible assets over their useful lives. The term <i>amortization</i> refers to the allocation of the cost of certain kinds of intangible assets over their useful lives.	The term <i>amortization</i> is used for the allocation of the cost of both depreciable tangible assets and certain kinds of intangible assets over their useful lives.
Closing entries	Other comprehensive income components are closed into accumulated other comprehensive income components.	Comprehensive income is not reported.