

10/8 - Lecture 2 - Accrual Accounting Concept

- The accounting cycle has the following steps
 1. Analyse transactions
 2. Journalise transactions
 3. Post transactions
 4. Prepare a trial balance
 5. Journalise and post adjusting entries
 6. Prepare an adjusted trial balance
 7. Prepare financial statements
 8. Journalise and post closing entries
 9. Prepare a post-closing trial balance
- Do 1-4 during the accounting period, do 5-9 at the end of the accounting period
- The nature and purpose of normal/adjusted trial balances is to ensure debits = credits
- In permanent accounts, the closing balances of one period become the opening balances of the next period

Accrual Accounting

- **Revenue** is recognised when an increase in assets or a decrease in liabilities becomes probable and can be measured reliably
 - ↳ Usually occurs at the time when goods are delivered or services are provided
- **Expenses** are recognised when a reduction in assets or an increase in liabilities becomes probable and can be measured reliably
 - ↳ Usually occurs when there is a decrease in future economic benefits for G/S received
- One of the underlying assumptions in the conceptual framework is that the statement of financial position and the statement of profit or loss should be prepared on an accrual basis
- **Income:** increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than that relating to contribution from equity participants
 - ↳ Equity participants = shareholders → raising cash from issuance of shares ≠ income
 - ↳ Income is recognised when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen and can be measured reliably
- **Expenses:** decreases in economic benefits during a period in the form of outflows or depletion of assets or increases of liabilities that result in a decrease in equity, other than that relating to the distribution to equity participants
 - ↳ Equity participants = shareholders → paying dividends ≠ expense
 - ↳ Expenses are recognised when a reduction in future economic benefits related to a decrease in an asset or increase in a liability has arisen and can be measured reliably

Adjusting Entries

→ 2 main types of adjusting entries

1. Prepayments

- Prepaid Expenses (Asset): cash outflow precedes entity receiving G/S
- Revenue Received in Advance (Liability): cash inflow precedes the entity supplying G/S to customers → Sometimes called “unearned revenue”

2. Accruals

- Accrued Revenues: amounts not yet received or recorded for G/S that have been provided
- Accrued Expenses: the receipt of G/S precedes outflow of cash

Closing Entries

- **Temporary accounts** relate to only one accounting period, and should have zero opening balance at the start of each period
 - ↳ Income statement accounts are temporary, eg. revenues, expenses, dividends
- **Permanent accounts** are carried forward to future accounting periods
 - ↳ Balance sheet accounts are permanent, eg. asset, liability, equity
- Each revenue or expense account is closed to the Profit or Loss Summary account
- Profit or loss summary account is closed to the Retained Earnings account
- Dividends paid are closed to the Retained Earnings account
- This will result in all temporary accounts having a closing balance of zero
- Retained earnings account is updated, but not closed
- Closing revenue and expense accounts are as follows - with narration (To close ___ account)
 - ↳ Revenue accounts: debit the revenue account and credit the profit or loss summary
 - ↳ Expense accounts: debit the profit or loss summary and credit the expense account
 - ↳ The resulting (credit) balance in the P&L summary account will be the profit
- Closing P&L summary and dividends to the retained earnings account is as follows - with narration (To close ___ to retained earnings)
 - ↳ P&L summary account: debit P&L summary account and credit retained earnings
 - ↳ Dividends: debit retained earnings and credit dividends
- Then create the “post-closing trial balance”
 - ↳ This will only have asset, liability and equity (including retained earnings)