Accounting Earnings versus Stock Prices

- A second reason for using accounting earnings
- Expected versus delivered performance
  - Firm X hires manager Y on December 31, 1997.
  - Stock price of X jumps by 10%!   Why?
  - Market's **expectations** regarding the company's future performance improve.
  - Accounting earnings of 1998 increases by 10%!
    - Why?
    - Manager Y's actions produce an **actual** improvement in the financial performance of X in 1998. Stock prices anticipated this improvement in 1997 at the time of the earnings announcement.

Accruals (Accrue Today, Cash Tomorrow)

- What would you see on the balance sheet as of 12/31?
  - Wages Payable $4,000 under Liabilities
- What would you see on the income statement for the **year ended** 12/31?
  - Wage Expense of $520,000
  - 52 Weeks x $10,000 per week
- Without the adjusting entry
  - Wage expense would have been $4,000 less.
  - Expense would have been understated
  - Net income overstated

Accruals (Accrue Today, Cash Tomorrow)

- Assets = L + Owners' Equity
- Cash Int. Receivable Retained Earnings
- +400 -200 +200
- Dr Cash (+A) 400
-     Cr Interest Receivable (-A) 200
-     Cr Interest Revenue (+RE) 200
- Two elements to the journal entry
  - Exchange of one asset for another asset
  - Record revenue earned and cash received

Cost Expirations (Cash Yesterday, Accrual Today)

- What happens during 1999?
  - One-year's worth of insurance protection expires
- How to record this in financial statements?
- Assets = L + Owners' Equity
- Prepaid Insurance Retained Earnings
- -500 -500
- Dr Insurance Expense (-RE) 500
- Cr Prepaid Insurance (-A) 500
- Effect of omitting this journal entry?
  - Assets are overstated by $500
  - Retained earnings (income) overstated by $500

Cost Expirations (Cash Yesterday, Accrual Today)

- Effect on financial statements?

	2000	2001
Operating cash inflow (+)	+5,000	
Subscription revenue (+RE)	+3,000	+2,000

- What do you see in the balance sheet as of 12/31/2000?
  - Liabilities: Unearned Revenue = $2,000
  - Represents the obligation for unfulfilled journal subscriptions.

Cost Expirations (Cash Yesterday, Accrual Today)

- **Depreciation**
  - Dewey, Inc. invests $10,000 in a quality control equipment on January 1, 1990. Dewey's management estimates initially that the equipment would last for ten years and would be scrapped thereafter.
- Assets = L + OE
- Cash Equipment
- -10,000 +10,000
- Dr Equipment (+A) 10,000
- Cr Cash (-A) 10,000

Cost Expirations (Cash Yesterday, Accrual Today)

- How to record depreciation expense?
- Equipment Retained Earnings
- -1,000 -1,000
- One possibility is
- Dr Depreciation Expense (-RE) 1,000
- Cr Equipment (-A) 1,000
- However, this is not GAAP.
- What might be the potential limitations of this approach?

Cost Expirations (Cash Yesterday, Accrual Today)

- How do accountants record depreciation?
- Dr Depreciation Expense (-RE) 1,000
- Cr Accumulated Depreciation (-A) 1,000
- Acc. Dep. is a **contra** (negative) **asset** account
- Decreases in assets are credits
- So, Acc. Dep. has a credit balance
  - Represents the cumulative depreciation on an asset
  - Informs the user about the age of the asset