Accrual Accounting Process: Part II



15.511 Corporate Actounting
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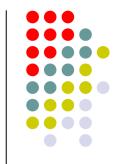
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Cash Flow Versus Accrual Accounting



- Over the entire of a corporation, total "income" underwash flows and accrual accounting is the Psame.
- However, cash receipts in a particular period may largely reflect the effects of activities of the enterprise in earlier periods.
- Similarly, many of the cash outlays may relate to activities and efforts to be undertaken in future periods.
- The matching principle in accrual accounting addresses this limitation of cash flow accounting.

Accounting Earnings versus Stock Prices



- Top management's incertaive compensation is usually linked to stock prices and accounting earnings.
- Why not link it to stock prices alone?
 - Stock prices are affected by economic factors that are outside of a manager's control (e.g., macroeconomic, political factors).
 - Consequently, stock prices may be a poor indicator of managerial performance.
 - Combining both mitigates this problem

Accounting Earnings versus Stock Prices



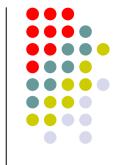
- A second reason foresing accounting earnings
- Expected Versus delivered performance Prim X hiles manager Y on December 31, 1997.
 - Stock price of X jumps by 10%! Why?
 - Market's <u>expectations</u> regarding the company's future performance improve.
 - Accounting earnings of 1998 increases by 10%!
 - Why?
 - Manager Y's actions produce an <u>actual</u> 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**)



- Periodic adjustment enese eember 31
 Assets from Assets from 26 of 52 Owners' Equity
- **Retained Earnings**
- +200 +200
- **Dr Interest Receivable (+A)** 200
- Cr Interest Revenue (+RE) **200**
- Effect of omitting this journal entry?
 - Assets are understated by \$200
 - Retained earnings & Net income each understated by \$200

Cost Expirations (Cash Yesterday, Accrual Today)



		s Account sale. CO. u.
Beg bal Purchases	N 5907 Pag	Note 52 of 52 applies expense
Ending Inv	300	

- Supplies expense of \$900 is the adjusting entry and the corresponding debit is to Retained Earnings (i.e., expense on the income statement that affects retained earnings).
- The Ending Inventory of \$300 appears on the balance sheet (and it serves as the ending inventory for the current fiscal period and beginning inventory for the following fiscal period).

Cost Expirations (Cash Yesterday, Accrual Today)



- What happens during 2009?
 - One-year's worth of insurance protection expires
- Hewito recordethis 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)



- Company B
- Consider two Companies

 Freview from 48 of Company A

 Equipment age 10,000
- Instead of this disclosure, let us consider an alternative approach
- 100,000 20,000 Equipment (cost)
- (-) Depreciation to date (90,000)(10,000)
- 10,000 10,000 **Net Book Value**
- What do you learn from the second approach?