Accrual Accounting Process: Part II

15.511 **Corporate Accounting**

Summer 2003

Professor S.P. Kothari

Sloan School of Management

Massachusetts Institute of Technology

June 14, 2003

Cash Flow Versus Accrual Accounting

- Over the entire life of a corporation, total “income” under cash flow and accrual accounting is the same.
- 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 incentive 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 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)

- Periodic adjustment on December 31
- Assets = L + Owners' Equity
- Interest Receivable 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)

Supplies Account

Beg bal	**500**	**900**	**Supplies expense**
Purchases	**700**		
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 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)

- Consider two Companies

	Company A	Company B
Equipment	10,000	10,000

- Instead of this disclosure, let us consider an alternative approach

Equipment (cost)	100,000	20,000
(-) Depreciation to date	(90,000)	(10,000)
Net Book Value	10,000	10,000

- What do you learn from the second approach?