Week two discussion questions

16 June 2008 Week 2 Discussion Questions What are the different bases of accounting? There are two different bases of accounting namely accrual and cash. These two differ in the timing of recording transactions. While cash basis accounting reports transaction when cash is paid or received, accrual accounting recognizes revenue as they occur even when the company has not yet generated cash from the customer and incurs expenses even when cash has not yet been paid.

How are the financial statements related?

Financial statements are related in the sense that they should not be taken individually when viewing the financial performance of a business organizations. For a prospective investor, considering the four financial statements is imperative in getting a clear picture of a company’s stance. For example, the items in the company’s balance sheet can be explained by the items in its income statement. On the other hand, the changes in the company’s retained earnings reports are generated both from the income statement and balance sheet. Lastly, the cash in the current assets section of the balance is further explained by the more extensive statement of cash flow.

How do adjusting entries for prepaid items work?

Companies using accrual accounting need to prepare adjusting entries for prepaid items. These adjusting entries give a more adequate picture of the company’s assets by subtracting the amount in the prepaid expense which is already consumed. For example, company A purchases prepaid insurance at the amount of $1200 during Jan 1 which is consumable for one year which it records as a debit in prepaid expense. At each end of the month, adjusting entries which include crediting prepaid expense by $100 should be undertaken in order to reflect the true amount of prepaid insurance in its portfolio.

How do adjusting entries for accruals work?

An example of adjusting entries for accruals is the case of employees' salary which companies incur each day of the month but is paid at the first day of the following month. At the end of the month, the company debits salary expense and credits salary payable of the amount. However, during the first of the month adjusting entry is made to indicate that this salary is now paid. This is done by debiting salary payable and crediting cash.

What are closing entries?

Closing entries are necessary in order to put temporary accounts in their final destinations. It should be noted that revenue, expenses, and capital withdrawal accounts are temporary and should be zero at each start of accounting period. Thus, the following closing entries are made: close revenue accounts to income summary; close the expense accounts to income summary; close income summary to retained earnings; and close dividends or capital drawings to retained earnings.

References

Horngren , C. et. al.. 2000, Accounting. 4th ed. New Jersey: Prentice Hall