Course work on accounting cycles

Business, Company

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Accounting Cycles

Adjusting Entries: These are entries made at the end of an accounting year usually at the end of year. These are journal entries to ensure incomes and expenses are allocated in the period that they were earned and incurred respectively. The money may not have been received or paid out in the particular period but the expenses and income are accounted for in the particular year they were earned or incurred. This is known as accrual accounting. It is also the principle of matching principle since revenue and associated costs are accounted for in the same accounting period. There are four types of adjusting entries:

Prepayments: A business may receive payment of goods and services before it has delivered the goods or completed the delivery of services. This is unearned income that has to be accounted for. The company that has received the payment records the income in an unearned income liability account. It is a liability for the company since it owes goods and services to another company. For the company that has made a prepayment this is an asset since they have prepaid for their expenses. The amount is recorded in prepaid expense asset account. The account will then be expensed with time

for expenses such as rent and insurance or with consumption of goods. For example, let us say a manufacturing company has paid the rent for the building the factory plant is in three months in advance. Each month the rent is $5, 000 yet the company has paid $15, 000. The accounting entries will be as follows:

Debit

Credit

Jan 1st 2011

Prepaid rent expense

$15, 000

Cash

$15, 000

Jan 31st 2011

Rent Expense

$5, 000

Prepaid rent expense

$5, 000

Accruals: These are services and goods that have been received and consumed but the payment is yet to be done. They have been accrued. For

example in a manufacturing firm the company has many casual, contract and permanent employees. The employees are paid at the end of January or the beginning of February for the work they did in January. (Accounting Aid, 2002). This is known as accrued expense for the company. If the salary expenses for a month are $30, 000 the accounting entries in the journals will be as follows:

Debit

Credit

Jan 1st 2011

Salary Expense

$30, 000

Salary Payable

$30, 000

Jan 31st 2011

Salary Payable

$30, 000

Cash

$30, 000

Estimates: There are provisions that have to be estimated such as depreciation and bad debt. They serve to decrease the value of fixed assets and debtors. This is known as prudent accounting principle. The accountant wants the books to reflect the true realizable values of the assets. The assets should be at the current market price. If there are debtors who have bad credit history or are rumored to be going bankrupt the money from such debtors may not be received at all. A provision should be made in the accounts (Business Accounting Guides, 2008). For a company having debtors worth $ 4000 yet it has been realized 2% of those debtors may not be able to pay the money the entries will be as follows:

2% of $4000=$ 80

Debit

Credit

Dec 31st 2011

Bad debts

$80

Debtors

$80

The amount reflected in the balance sheet for debtors will therefore be $4000-$80=$3920.

Inventory: A manufacturing company will have to calculate the cost of goods sold. In the beginning of the year the purchases account will be debited with stock that has been purchased and credited with any stock that has been returned to suppliers. The account is also credited with purchase discounts as it reduces the cost of purchases. The account is also credited with carriage or transport costs incurred to transport the goods to the factory plant. The inventory account shows the inventory at the beginning of the year. It needs to be adjusted to reflect the inventory at the year end (White, 1999)For a company having sales of $60, 000, purchases of $50, 000, purchase discounts of $5000, transport of $2000, purchase returns of $500 and opening inventory of $ 18000 calculation for cost of goods is as follows:

Sales

$60, 000

Purchases

$50, 000

Add purchase transport cost

$2, 000

Less Purchases returns

($500)

Less Purchase discounts

($5, 000)

$46, 500

Cost of goods sold

13, 500

The inventory account will be adjusted with the cost of goods sold to reflect the true inventory stock value in the store as follows:

Debit

Credit

Dec 31st 2011

Cost of goods sold

$13500

Inventory

$13, 500

This inventory value is what is known as the closing stock.

Ethical issues in preparation of adjusting entries:

In a company the higher management is very prone and vulnerable in

1) Overstating profits. When expenses are not matched to the period of accounting both prepaid and accrued then the profits will be overstated. This

lies to the existing shareholders and potential shareholders about the profitability and growth of the company. It makes the people buy shares of the company only to be greatly disappointed afterwards. This is usually aggravated by pegging executive allowances and salaries or incentives on the company performance(Singleton et al, 2006)

2) Understating provisions: The managers may also not adjust accounts to the realizable values of assets and investments. They understate depreciation and bad debts. They may also not provide for legal fees where they may be facing possible legal claims and fees. This also leads to misrepresentation of accounts and the profits of the company.

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