

# Working with financial statements

[Finance](#)



Working with Financial Statements Accounting is the heart and soul of executing a successful business. Accounting is used to provide record for all items that are paid and received for a business over any period of time. Within the purpose of accounting lies the need to provide continuity and sustainability within a business, without it a business will not thrive. The information obtained is kept on record, in order to give insight to upper management on data concerning the daily revenue and expenses of that business. This data is needed to not only inform the employees of the business, but also the investing parties of that business as well.

Success in business is equated to being accountable of all aspects of revenue and expenses. To help aid in the understanding of the practice of accounting, Team A will discuss the subjects of revenue and expense recognition principles. We will also discuss the importance of journal adjustments that are prepaid, unearned, and accrued for both revenues and expenses over time. Each item discussed helps provided and maintains a balance for the completion of a financial statement. If entered correctly, the all entries used will provide a clear picture of the account efforts of any business.

The Revenue Recognition and Expense Recognition Principle Being able to account for a business's revenues and expenses in a certain accounting period is difficult to determine. To do it correctly, one would need to understand two principles that set the standard; the revenue recognition principle and the expense recognition principle. In chapter 4 of our textbook Financial Accounting Tools for Business Decision Making, it states " the

revenue recognition principle requires that companies recognize revenue in the accounting period in which it is earned.

In a service company, revenue is considered to be earned at the time the service is performed. " Therefore, the definition is that it is only to be recorded when the items sold where the profit can be estimated reliability and when the amount is recoverable. What tells the revenue to be recognized and to ignore when the cash inflows occur is when the account will use the accrual basis of accounting. An example to illustrate revenue recognition principle is when a phone company sells talk time through scratch cards. There is no revenue to recognize when a customer purchased the scratch card.

The revenue is recognized when the customer has made the call and actually consumed the talk time. The expense recognition principle is defined in the same chapter as, " The principle that dictates that companies match efforts (expenses) with results (revenues). " They provide a simple rule to remember as " Let the expenses follow the revenues. " which would indicate how the expense recognition goes hand and hand with the revenue recognition. To illustrate that, we could say it is sales commission owed to an employee because it is based on the total of a sale.

In the same accounting period as the sale, the commission expense is when it should be recorded. At the same time, the sale is recognized and expensed when the cost of inventory is delivered to the customer. That is when the commission expense should be recorded in the same accounting period as the sale. That would be the example of the matching principle is associated with the cause and effect of accounting. Situations That Require Adjusting

Journal Entries Adjusting entries are grouped as deferrals and accruals and each has two subgroups. The two categories of deferrals are prepaid expenses and unearned revenue.

Prepaid expenses are recorded as assets until they are used or consumed. For example prepaid monthly insurance is recorded as an asset until the coverage has been consumed. Because prepaid expenses expire with time does not require daily adjustments, which would be unrealistic. When preparing financial statements adjusting entries are made to record the expense consumed of the prepaid assets and show the remaining amounts in the asset account. Unearned revenue is when cash is received before service is provided, which increases the liability account. For that reason unearned revenue are opposite of prepaid expenses.

When a company receives a payment for a future service, it credits liability the unearned revenue account increases. The recognition process occurs during the accounting period where the service was provided. Then the company makes the adjusting entry for the unearned revenue by debiting the liability account and crediting the revenue account. Before the adjustment is made liabilities are overstated and revenue is understated. The second category for adjusting entries is for accruals. Preceding the entry adjustments the revenue account or the expense account are understated.

Consequently the entry adjustment for accruals increases the balance sheet and income statement account. Accrued revenue is accumulated revenue that is not recorded at the statement date because revenue is accrued with passing time, which is impractical to record daily. The adjusting entry records the amount owed to a business at the balance sheet date and the

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revenue earned in that time. The adjusting entry increases both the revenue account and the asset account. If services provided to client that were not billed will not be recorded.

The accrual of unrecorded service account increases accounts receivable, which also increases stockholder equity by increasing revenue account. It would be unethical for a company to backdate sales or accounts receivable to increase revenue and asset accounts to meet a quarter's target sales. Expenses incurred but not yet paid or recorded at the statement date are called accrued expenses. Adjustments are made to recognize expenses incurred at the current accounting period and record debt that is present at the balance sheet date. Consequently adjusting entry increase expense account and increase liability account.

Why Adjusting Entries are Important Every business or organization makes adjusting entries in the end of a set accounting period. Adjusting entries are entries made at the end of an accounting period to make certain that the profits and expenditures recognition principles are followed (Kimmel, Weygandt, & Kieso, 2011). Accrual transactions and the purposes of these transactions should be reported when these financial actions occur. These actions should be recorded not only when cash is paid or received but also anytime a financial action takes place.

These important concepts in accounting are imperative because they recognize net gains or losses and a business' financial position can be identified within the accounting period. The preparations of general entries and postings are important and the information added to these journals should be precise and reliable. The truth in numbers is critical, and the <https://assignbuster.com/working-with-financial-statements/>

information should be calculated exactly. There are numerous reasons regarding why adjusting entries are important. To establish if the accurate value of cost of goods sold and gross profit, adjusting entry of closing stock is needed.

To determine the correct value of net profit, adjusting entry of depreciation is needed. Making adjusting entries of advance expenses are essential because after this step is completed an accountant can take away advance expense from expenses collected, and this will be charged in next accounting period when these expenses will be payable. To show the correct amounts due to a third party and to show correct expenses for the accounting period making adjusting entries of outstanding expenses are important. In this entry the accountant must have debit expense and credit outstanding expense for a third party accounted for. Conclusion

As one can see, revenue recognition and expense recognition are important parts of the accounting process of any business. It is also important to understand what situations require a company to adjust their journal entries and why it is so important to do so. With the appropriate accounting techniques and accurate journaling, a company's financial statements become more accurate and easier for both internal and external users to understand. Not only do accurate financial statements keep a company above suspicion and consequence, but it helps users make informed decisions about that company based on its financial health.

Without good decision making based on accurate information, a company will not be able to succeed. References Kimmel, P. D. , Weygandt, J. J. , & Kieso, D. E. ( 2010). Financial accounting: Tools for business decision making <https://assignbuster.com/working-with-financial-statements/>

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