Accounting Principles and their implications to period end adjustments

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Accounting Cycle

1. Analyze business transactions
2. Journalize the transactions
3. Post to ledger accounts
4. Prepare a trial balance
5. Journalize and post adjusting entries
6. Prepare an adjusted trial balance
7. Prepare financial statements
8. Journalize and post closing entries
9. Prepare a post-closing trial balance

GENERAL JOURNAL

Date		Account Titles	Debit	Credit
Oct	31	Salaries expense	1,200	
		Salaries payable		1,200

Account Name

Dr Cr

Accounting Principles and their implications to period end adjustments

- Underlying Assumptions
- Accrual Basis of Accounting
- Examples for discussion
  - Allowance for doubtful debts
  - Dividends
- Qualitative Characteristics of Information

Underlying Assumptions

- Going concern assumptions
- Time period assumptions
- Revenue Recognition Principle
- Expense Recognition (Matching) Principle

Going Concern Assumption

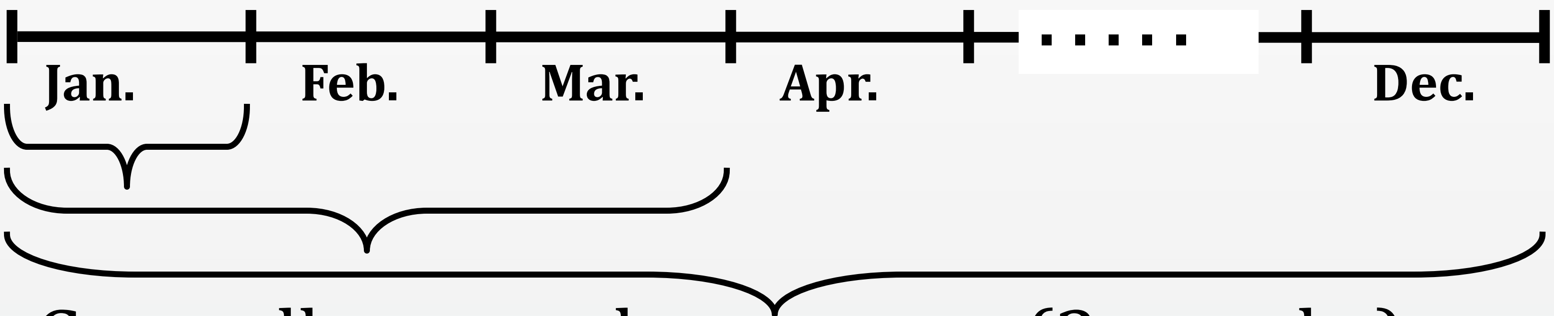
- Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future.

- General purpose financial statements are prepared using the going concern basis of accounting, unless management either intends to liquidate the entity or curtail materially the scale of its operations, if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

- Eg. Current Assets and Non-current assets classification(eg.PPE)

Time-Period (Periodicity) Assumption

- Accountants divide the economic life of a business into artificial time periods (Time Period Assumption).



- Generally a month, a quarter (3 months), semi-annual (6 months), or a year.
- Fiscal year (e.g. 1/Apr./Yr. 1 – 31/Mar./Yr. 2, 1/July/Yr.1 – 30/June/Yr. 2, etc.) vs. calendar year (Jan. – Dec./Yr. 1)
- Eg. Accounting for *interest revenue*

Revenue Recognition Principle

- Revenue should be recognised when (or as) an entity transfers control of goods or services to a customer at the amount to which the entity expects to be entitled.
- Depending on whether certain criteria are met, revenue is recognised over time, in a manner that best reflects the entity's performance; or
- at a point in time, when control of the goods or services is transferred to the customer.

Expense Recognition (Matching) Principle

- Match expenses with revenues in the period when the company makes efforts to generate those revenues.

Revenue & Expense Recognition

Time-Period Assumption

Divide economic life of a business into artificial time period

Revenue-Recognition Principle

Recognize revenue in the accounting period in which the performance obligation is satisfied.

Expense-Recognition Principle

Match expenses with revenues in the period when company makes efforts to generate those revenues

Accrual-basis Accounting

(IFRS required)

Accrual Basis of Accounting

- Transactions are recorded when they occur.
- Revenues are recorded when the performance obligation is satisfied.
- Expenses are recorded only when incurred.
- IFRS requires accrual basis accounting.

The Basics of Adjusting Entries

Trial balance **may not** contain up-to-date & complete data

⇨ need adjusting entries.

- To be prepared whenever financial statements are prepared.
- To report correct amounts on the **financial statements.**
- To ensure that **revenue recognition** and **expense recognition principles** are followed.

Examples for Adjusting entries

- Allowance for doubtful debts
- Dividends

Accounts receivable

- Amounts due from customers
- Claims expected to be collected in cash

Allowance for doubtful Account

- Estimate and record 'uncollectible' accounts at the end of each period.
- Losses are estimated before actual write off
- For 'matching' purpose, bad debt expense should be recorded in the same accounting period in which the sales related to the uncollectible account were recorded.
- Required by IFRS.
- Eg. Percentage-of-receivables basis
- The adjusting entry to record the estimated uncollectibles at the end of the period:

  Dr Bad debt Expense

  Cr Allowance for doubtful Accounts

Allowance for doubtful Account

- What is the nature of the Allowance for doubtful Account? (Contra –asset)
- What is the normal balance of Allowance for doubtful Account? (Credit balance)

Allowance Method

Percentage-of-receivable

- Emphasis on Realizable Value
- Matching Accounts Receivable with Allowance for Doubtful accounts

Contra account of A/R.

ABC Limited
Statement of Financial Position
December 31, 20X7 (partial)

Current assets		
Cash		$14,800
Accounts Receivable	$200,000	
Less: Allowance for doubtful accounts	12,000	188,000
Merchandise inventory		310,000
Prepaid Insurance		25,000
Total current assets		537,800

Cash realizable value: the net amount of accounts receivable that the business expects to collect (i.e. converted into cash).

Allowance method : Percentage of receivable

%-of-receivables (Statement of Financial Position Approach)

- Use the historical relationship between accounts receivable and bad debt losses
- The multiple rates (known as aging of receivables), are applied to the net accounts receivable to determine the desired balance in the Allowance for Doubtful Accounts.
- Bad Debt Expense: the adjustment necessary to bring the Allowance account to its desired ending balance.

❶ Compute the estimate of the Allowance for Doubtful (Uncollectible) Accounts: Year-end Accounts Receivable *x* Bad debt %

❷ Bad Debts Expense:

	Estimated Adjusted Balance in Allowance for Doubtful Accounts
-	**Unadjusted Year-End Balance in Allowance for Doubtful Accounts**
=	**Estimated Bad Debts Expense**

Allowance method : Percentage of receivable (Aging of receivables)

Dec.31, 20X7, the receivables for XYZ. were as follows:

Customer	Balance	Not Past Due	Days Past Due 1-30	31-60	61-90	91-180	181-365	over 365
Apple Co.	$ 150			$ 150				
Grape Co.	610					$ 350	$260	
Kiwi Co.	470	$ 470						
Orange Co.	160							160
Total	$86,300	$75,000	$4,000	$3,100	$1,900	$1,200	$800	$300
Uncollectibles %		2%	5%	10%	20%	30%	50%	80%

Allowance method : Percentage of receivable

(Aging of receivables)

			Days Past Due					
Customer	Balance	Not Past Due	1-30	31-60	61-90	91-180	181-365	over 365
Apple Co.	$ 150			$ 150				
Grape Co.	610					$ 350	$260	
Kiwi Co.	470	$ 470						
Orange Co.	160							160
Total	$86,300	$75,000	$4,000	$3,100	$1,900	$1,200	$800	$300
Uncollectibles PERCENT		2%	5%	10%	20%	30%	50%	80%
AMOUNT	$3,390	=$1,500	$200	$310	$380	$360	$400	$240

Allowance method : Percentage of receivable

General Ledger

Accounts Receivable

86,300	

Allowance for Doubtful Acct.

	510
	2,880
	3,390

Bad Debt Expense

2,880	

Unadjusted credit balance in "allowance account": $510

Desired balance: **$3,390**

Statement of Fin. Position

Accounts receivable	**$86,300**
Less: Allowance for doubtful accounts	**3,390**
Net realizable value	**$82,910**

Date		Account Titles and Explanation	Debit	Credit
20X7		Bad debt expense *($3,390 - 510)*	2,880	
Dec	31	Allowance for doubtful accounts		2,880

Allowance method : Percentage of receivable

- The General Manager of XYZ Co. authorized a write-off of the $160 balance owed by Orange Co. on Jan 20, 20X8:

Date		Account Titles and Explanation	Debit	Credit
20X8		Allowance for doubtful accounts	160	
Jan	20	Accounts Receivable - Orange		160
		To write off an uncollectible account		

Note: Bad Debt Expense ***is not*** debited

The actual write-off entry for $160 does not reduce net receivables:

	Before	After
Accts. Receivable	$86,300	$86,140
Less: Allowance for Doubtful Accounts	3,390	3,230
Net Receivables	$82,910	$82,910

What if the bad debt expense is debited?

- Bad debt expense balance = $160
- Allowance for doubtful accounts balance will be overstated by $160

At the year end of 20x8: If the required balance of the allowance for doubtful accounts is $5000

Adjusting entries:

<u>Without the bad debt expense balance of $160</u>

Dr Bad debt Expense	1,770		Final balance of bad debt expense: $1,770
Cr Allowance for doubtful accounts		1,770	
($5,000 - $ 3,230)			

<u>With the bad debt expense balance of $160</u>

Dr Bad debt Expense	1,610		Final balance of bad debt expense: $1,610 + $160 = $1,770
Cr Allowance for doubtful accounts		1,610	
($5,000 - $3,390)			

Dividends

- If dividends are declared (ie the dividends are appropriately authorised and no longer at the discretion of the entity) after the balance sheet date reporting period but before the financial statements are authorised for issue, the dividends are not recognised as a liability at the balance sheet date end of the reporting period because they do not meet the criteria of a present obligation in HKAS 37 no obligation exists at that time.

- Such dividends are disclosed in the notes to the financial statements in accordance with HKAS 1 Presentation of Financial Statements*.

Dividends

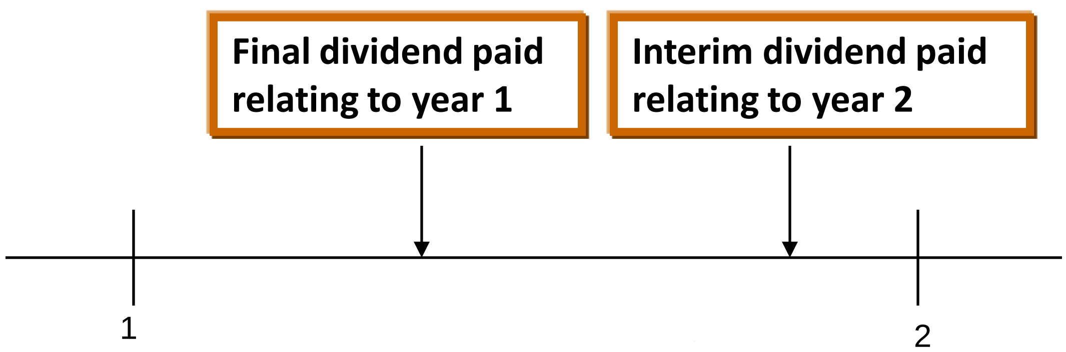
- Ordinary shareholders may receive dividends twice each year, an interim dividend during an accounting year and a final dividend after the reporting date.
- ***Interim dividend*** declared by the directors and paid during the year.
- ***Final dividend*** is paid after it has been proposed and approved by the shareholders at the AGM in the following year.

There are usually three possible cases for final dividend:-

① Declared ***before*** the end of the reporting period

② Declared ***after*** the reporting period ***but before*** the issue date of financial statement

③ Declared ***after*** the reporting period ***and*** the issue date of financial statement



Final Dividend

	Three possible cases	*Accounting Treatment*
1	Declared before end of the reporting period	Dr Dividend declared Cr Dividend payable (liability)
2	Declared after the reporting period but before issue date of financial statement	Dr Dividend declared Cr Proposed dividend (equity) or Just note disclosure
3	Declared after the reporting period and issue date of financial statement	No action until next accounting period

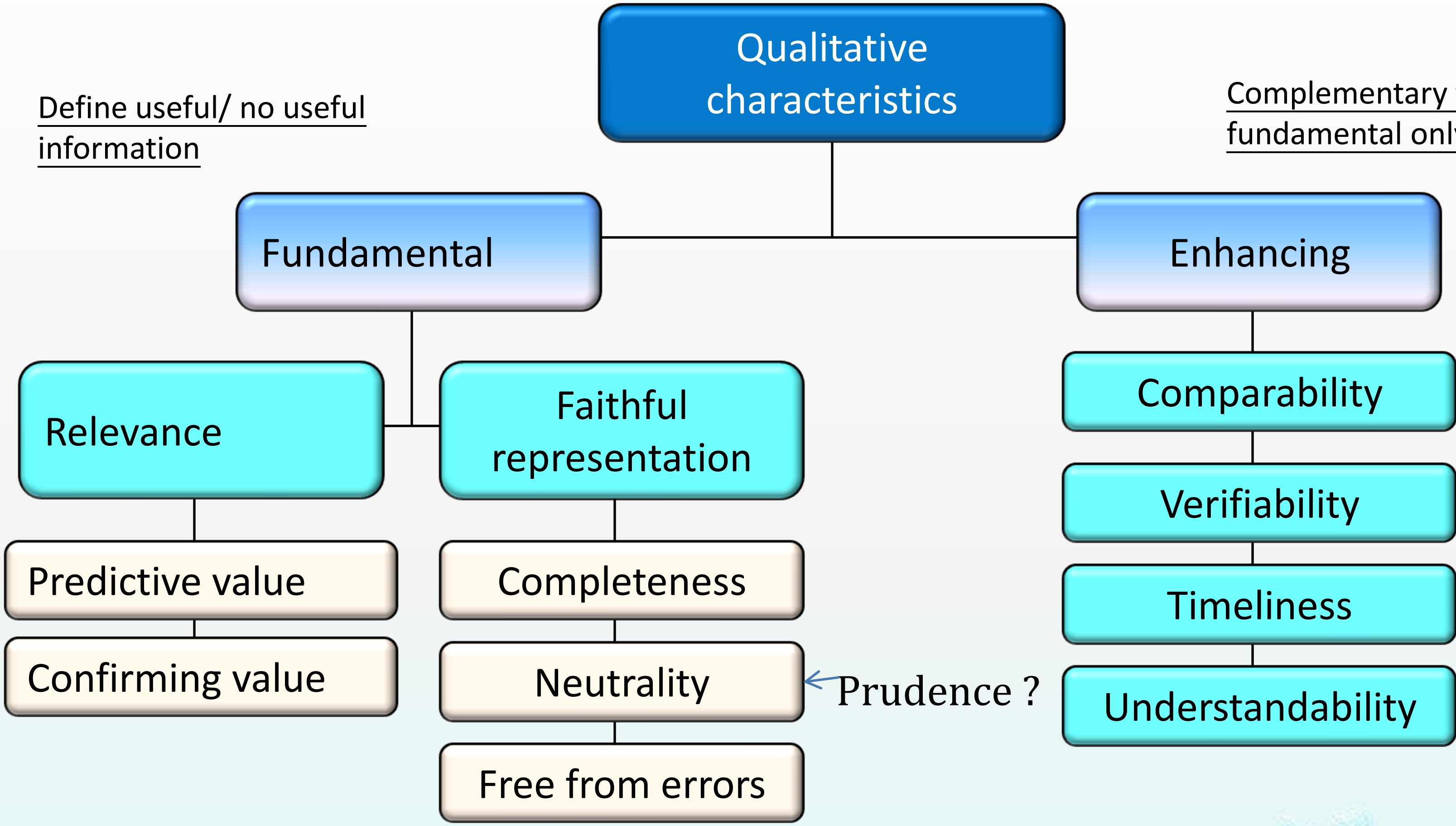
Qualitative Characteristics of Information

- **Two** *fundamental* qualitative characteristics which constitute the essence of useful information:
  - relevance
  - faithful representation

- **Four** *enhancing* qualitative characteristics which will enhance the usefulness of information:
  - comparability
  - verifiability
  - timeliness
  - Understandability

- Enhancing qualitative characteristics are considered to be complementary to the fundamental qualitative characteristics.

Hierarchy of Qualitative Characteristics



Relevance

Qualitative characteristics of useful financial information

Fundamental
Relevance
Faithful Representation

Enhancing
Comparability
Verifiability
Timeliness
Understandability

Relevant if it is ***capable of making a difference*** in the decisions made by users.

- This quality helps users to:
  - evaluate past, present or future events (Predictive Value);
  - confirm or correct their past evaluations (Confirming Value)

- *Relevance* of information is affected by its ***nature*** and ***materiality***.
  - **Nature** alone may be sufficient to determine relevance, e.g. non-disclosure of director's loan.
  - **Materiality** (entity-specific) is threshold or cut-off point that needs to be considered before considering other qualities

Faithful Representation

Qualitative characteristics of useful financial information
Fundamental
Relevance
Faithful Representation
Enhancing
Comparability
Verifiability
Timeliness
Understandability

Faithful representation means that the information *presents the substance*.

- It encompasses
  - ***completeness*** – includes all information necessary for a user to understand the phenomenon with all necessary descriptions and explanations.
  - ***neutrality*** - without bias in the selection or presentation of financial information
  - ***free from error*** - no errors or omissions in the description of the economic phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process

Understandability and Comparability

Qualitative characteristics of useful financial information
Fundamental
Relevance
Faithful Representation
Enhancing
Comparability
Verifiability
Timeliness
Understandability

- *Understandability*
  - Assumed readily understood by users who
    - Have **reasonable knowledge** of business and economic activities and accounting
    - Are **willing to study** information
    - Have **reasonable diligence**
  - **Complex matters** should not be excluded
- *Comparability*
  - Users must be able to compare an entity's financial statements:
    - ***through time*** to identify trends
    - with ***different entities'*** statements, to evaluate their relative financial position, performance and changes in financial position.
  - Comparability is the goal; consistency helps to achieve that goal.

Timeliness and Verifiability

Qualitative characteristics of useful financial information

Fundamental

- *Relevance*
- *Faithful Representation*

Enhancing

- *Comparability*
- *Verifiability*
- *Timeliness*
- *Understandability*

- *Timeliness*- means having information available to decision-makers in time to be capable of influencing their decisions.
  - More time, more reliable but less relevant
- *Verifiability* - means that different knowledgeable and independent observers could ***reach consensus*** that a particular depiction is a faithful representation.
  - the CF recognizes that such users may not reach complete agreement.
  - but, a range of possible amounts and related probabilities can also be verified.

Q & A?