

40.1 An exercise on the potential abuse of accounting for accruals, etc.

State and explain the effect of each of the following actions or situations on the reported profit of the current period and on the firm's net assets at the end of the period:

1. making an inappropriate (excessive) adjustment for deferred income

Response

An inappropriate (excessive) adjustment for deferred income would reduce the reported profit of the current period by pushing some of the sales recorded in the current period into the P&L Account of the next period. It would also reduce reported net assets in the balance sheet by creating an unnecessary current liability.

2. making an inappropriate (excessive) adjustment for accrued income

Response

An inappropriate (excessive) adjustment for accrued income would increase the reported profit of the current period by pulling some of the sales to be recorded in the next period into the P&L Account of the current period. It would also increase reported net assets in the balance sheet by creating an unnecessary current asset.

3. making an inappropriate (excessive) adjustment for a prepayment

Response

An inappropriate (excessive) adjustment for a prepayment would increase the reported profit of the current period by pushing some of the expenses recorded in the current period into the P&L Account of the next period. It would also increase reported net assets in the balance sheet by creating an unnecessary current asset.

4. making an inappropriate (excessive) adjustment for an accrual

Response

An inappropriate (excessive) adjustment for an accrual would reduce the reported profit of the current period by pulling some of the expenses to be recorded in the next period into the P&L Account of the current period. It would also reduce reported net assets in the balance sheet by creating an unnecessary current liability.

5. failing to make an appropriate adjustment for deferred income

Response

Failing to make an appropriate adjustment for deferred income would increase the reported profit of the current period, by including in the P&L Account some sales that had not yet been delivered. It would also increase reported net assets in the balance sheet by failing to recognize the liability to deliver those sales in the next period.

6. failing to make a necessary adjustment for accrued income

Response

Failing to make a necessary adjustment for accrued income would reduce the reported profit of the current period, by failing to include in the P&L Account some sales that had been delivered in the period. It would also decrease reported net assets in the balance sheet by failing to recognize the right to receive payment for those sales as an asset.

7. failing to make a necessary adjustment for a prepayment

Response

Failing to make a necessary adjustment for a prepayment would reduce the reported profit of the current period, by failing to exclude from the P&L Account some expenses – already recorded or paid for – that had not been received or consumed in the period. It would also decrease reported net assets in the balance sheet by failing to recognize the right to receive or consume the relevant input as an asset.

8. failing to make a necessary adjustment for an accrual

Response

Failing to make a necessary adjustment for an accrual would increase the reported profit of the current period, by failing to include in the P&L Account some expenses – not yet paid for or recorded – that been consumed in the period. It would also increase reported net assets in the balance sheet by failing to recognize the liability to pay for the relevant inputs.

9. overestimating the useful life of a fixed asset

Response

Overestimating the useful life of a fixed asset would increase the reported profit of the current period, by reducing the depreciation expense reported in the P&L Account. It would also increase reported net assets in the balance sheet, by reporting a smaller provision for depreciation.

10. underestimating the residual value of a fixed asset

Response

Underestimating the residual value of a fixed asset would decrease the reported profit of the current period by increasing the depreciation expense reported in the P&L Account. It would also decrease reported net assets in the balance sheet, by reporting a bigger provision for depreciation.