



# Accruals and Prepayments Webinar

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# Accruals

According to the dictionary definitions of the word 'accrue' include:-

- Accumulate or receive (payments or benefits) over time
- Make provision for (a charge) at the end of a financial period for work that has been done but not yet invoiced.

**In the preparation of financial statements we apply the accruals concept. Income and expenditure is accounted for in the period to which it relates and not on a cash basis.**

To report the correct level of profit earned in a period all costs of resources consumed in order to trade must be included regardless of whether we have been invoiced for those resources or not.

## Illustration

Sales for a period are £10,000 and the costs recorded are £4,000. The electricity for the shop of £1,000 has not been billed.

The cost of electricity must be included in the costs of the business for the trading period as the electricity has been used to help generate the revenue. The true profit is therefore:-

$$£10,000 - £4,000 - £1,000 = £5,000.$$

If we didn't accrue for the electricity the profit would be £6,000 which doesn't account for all the costs of resources used.

We must ensure that we show an estimate of the cost incurred in the accounts at period end. What can that estimate be based on?

- Actual invoice is received in the early weeks of the next financial year so we can use the actual information to accrue.
- Previous invoices
- Expert within the company eg a facilities manager for building related work.

The double entry for making an accrual for expenditure is:-

**Dr Expense account**

**Cr Accrued expenditure**

The accrued expenditure account is a **liability** in the statement of Financial Position.



### Example 1

In the year a total of £12,000 has been recorded in the cashbook for software maintenance. This covers the period Jan to Sept. You are preparing the accounts for the year ended December. You have yet to be sent the invoice for the final quarter October to December. Show the entries in the software maintenance account for the year including the final transfer to the Profit or Loss account.

Software Maintenance					
Date	Description	Amount £	Date	Description	Amount £

Accruals					
Date	Description	Amount £	Date	Description	Amount £



What happens in the next period?

In the next period the actual invoice will be received and accounted for using the double entry

**Dr software maintenance**

**Cr supplier / bank**

So now software maintenance has been charged twice (debited) for the cost in 2 different periods. To remove this double counting the accrual is reversed (typically) at the start of the next accounting period.

### Example 2

Assume that it is now the start of the next financial year and we receive the actual invoice for the final quarter of the previous year. The invoice is for £4,100. Show the accounting entries required at the start of the year.

Software Maintenance					
Date	Description	Amount £	Date	Description	Amount £

Accruals					
Date	Description	Amount £	Date	Description	Amount £

The accrued expenditure from the previous period has been reversed and the actual invoice processed. The balance at this stage is £100 arising because the actual invoice was different to the accrual made.

Does it matter that there is a difference?

We will always try to make sure that our accrual is as accurate as possible based on the best available information. Any difference will be adjusted for in the following accounting period.

Getting to grips with accounting entries for the accrual and the subsequent reversal can be confusing. It is necessary to go back to the end of the previous accounting period to ensure you fully understand all the entries that have been made and that are still to be made.

**To summarise the adjustment for accruals for example 2**

Journal 31 December				
Date	Account	Amount £	Debit or Credit	Description

Journal 01 January				
Date	Account	Amount £	Debit or Credit	Description



### Example 3

You are preparing the accounts for the year end. During the year a total of £8,250 has been paid from the bank for electricity. This covers the period January to October. The last 2 invoices for November and December have yet to be received. You have asked the facilities manager for an estimate of the costs incurred and they have told you to accrue £1,200. At the end of the previous year an accrual was made for £1,600 but this has yet to be reversed. Show all of the accounting entries for the year including the final transfer to Profit or Loss.

Electricity					
Date	Description	Amount £	Date	Description	Amount £

### What about accrued income?

In the same way that we need to accrue for expenditure on resources consumed but not billed for at the end of a financial period so if we are involved with income accounts we should accrue for any income owed that we have generated in the period but at period end it hasn't been accounted for.

Now in reality this may seem strange as surely we should ensure as a trader that we invoice promptly and so the invoices would always be accounted for in the correct period. But there may be circumstances where this has not happened.

The logic is the same accrue the income but all of the accounting is reversed. The double entry would be:-

**Dr Accrued income**

**Cr Income account**

The accrued income account is an **asset** in the statement of financial position. Someone owes us for services supplied or products delivered.



#### Example 4

It is the year end December 2019. You are preparing the commissions received account. During the year £4,150 was received through the bank account for commissions. At the end of the previous year £800 was accrued for commissions. This has not been reversed. You have been told to accrue for £400 for commissions earned but as yet not invoiced. State the final transfer to Profit or Loss for the year.

To answer this draw up the General Ledger account

Commissions Received					
Date	Description	Amount £	Date	Description	Amount £



# Prepayments

According to the dictionary to 'prepay' means to pay in advance. So a trader may pay in advance for resources or services. Paying ahead of the period that the service is needed. To facilitate the accruals concept of financial accounting this expense needs to be deferred into the period to which the service or resource relates.

The double entry for a prepayment is:-

**Dr prepaid expenditure**

**Cr expenditure**

The prepaid expenditure account is an **asset** in the statement of financial position. It represents something of value that can be used for the benefit of the business in a future period.

## Illustration

Sales for a period are £10,000 and the costs recorded are £6,000. The rent for the shop of £1,000 for the next period has been recorded in the £6,000 as the invoice has been received.

The cost of rent for the next period must be excluded from the costs of the business for the trading period as the rent has not been used to help generate the revenue. The true profit is therefore:-

$$£10,000 - (£6,000 - £1,000) = £5,000.$$

If we didn't prepay the rent the profit would be £4,000 which doesn't account for the costs of resources used.



### Example 1

You are completing the rent account for the year end December 2019. During the year the bank shows expenditure of £16,000 for rent. This covers the period Apr 2019 – March 2020. At the end of the last financial year you prepaid £3,800 for rent. This entry has not been reversed. Show all of the entries needed to complete rent account for the year.

Rent account					
Date	Description	Amount £	Date	Description	Amount £

Prepayments					
Date	Description	Amount £	Date	Description	Amount £



## What about prepaid income?

Traders for example who are landlords may well invoice in advance for rent. But this could also be true of other services supplied. So when preparing income accounts for the period or year end they would need to ensure that all income accounted for is income earned in that period.

The double entry to prepay income is:-

**Dr Income account**

**Cr Prepaid income**

Prepaid income is a **liability** account in the statement of financial position.

### Example 2

You are preparing the year end accounts for December 2019. You have been asked to complete the rental income account. During the year a total of £23,150 was received in the bank account for rents. At the end of the previous year a prepayment had been made for £1,870 this has not been reversed. The bank figure of £23,150 includes invoices totalling £2,700 relating to rents for the first 3 months of 2020.

Rental Income					
Date	Description	Amount £	Date	Description	Amount £

Prepayments					
Date	Description	Amount £	Date	Description	Amount £

# Summary

## For expenditure

**Prepaid Expenditure = Current Asset**

**Accrued Expenditure = Current Liability**

## For income

**Accrued income = Current Asset**

**Prepaid Income = Current Liability**

## Tips

Make sure you don't get confused with questions

1. Determine if the question is about an expense or income account
2. Go back to the end of the previous financial period if reversals are mentioned and establish what accounting entries were performed
3. Regardless of whether the question includes completion of a T account or not use your working paper to draw a T account

**Good Luck!**

