

CH 3 — Accrual Accounting & the Financial Statements

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Summary

Chapter 3 formalizes **accrual accounting** (vs cash-basis), applies **revenue** and **expense (matching)** principles, records **adjusting** and **closing** entries, prepares statements in order, and previews liquidity/solvency analysis and trend visualization.

Learning objectives: explain accrual vs cash; apply recognition principles; record adjusting entries; prepare statements; record closing entries; assess debt-paying ability; recognize patterns with simple charts.

1. Accrual vs Cash-Basis Accounting

Aspect	Accrual Accounting	Cash-Basis Accounting
Recognition	When earned/incurred (event-based)	When cash is received/paid (cash-based)
FS quality	Complete — includes non-cash assets/liabilities	Incomplete — ignores non-cash events
Required by	IFRS / ASPE	Not generally accepted

Definition: accrual records revenue when **earned** and expenses when **incurred**, regardless of cash. Cash-basis records only cash receipts/payments.

Examples:

- Sale on account: accrual → record **Revenue** & **A/R** now; cash-basis → record later when cash arrives.
- Inventory on account: accrual → record **Inventory** & **A/P** now; cash-basis → record later when paid.

2. Recognition Principles

Revenue Recognition (3 conditions)

Record revenue **after** it's earned and for the **amount transferred** to the customer. All must hold:

- 1) Goods/services delivered.
- 2) Amount can be measured reliably.
- 3) Receipt is probable.

Examples:

- Costco sells a TV for \$500 and the customer takes it home → **Recognize revenue**.
- Costco orders a TV for pickup in 4 days (no delivery yet) → **Do not recognize revenue**.

Matching / Expense Recognition

Record expenses in the **same period** as the revenues they help generate. Conditions:

- 1) A decrease in future economic benefit (asset down or liability up).
- 2) Amount can be measured reliably.

Examples:

- COGS recognized **when related sale occurs**.
- No COGS when item hasn't been sold yet.

3. Adjusting Journal Entries (end-of-period)

Purpose: measure period income and update the balance sheet. Every adjusting entry affects at least one **Revenue/Expense** and one **Asset/Liability**.

Type	Description	Mini example
Deferrals	Cash first, recognition later	Prepaid insurance → expense as used; Unearned revenue → revenue when earned
Accruals	Recognition first, cash later	Accrued salaries; interest revenue receivable
Depreciation	Allocate tangible asset cost over life	Depreciation expense; Accumulated Depreciation (contra-asset)

Examples:

- Prepaid expense used: DR Expense, CR Prepaid (asset).
- Unearned revenue earned: DR Unearned (liability), CR Revenue.
- Accrued expense: DR Expense, CR Payable.
- Accrued revenue: DR Receivable, CR Revenue.
- Depreciation: DR Depreciation Expense, CR Accumulated Depreciation.

4. Preparing Financial Statements (order matters)

Statement	Purpose
Income Statement	Revenues and expenses → Net income
Statement of Retained Earnings	Beg RE + NI – Dividends → End RE
Balance Sheet	Assets, liabilities, and shareholders' equity

Why this order: IS provides **NI** for RE; RE provides **End RE** for BS. (SCF is addressed later.)

Formats:

- Balance Sheet: **Report format** (A over L+E) or **Account format** (A left, L+E right).
- Income Statement: **Single-step** (all rev, all exp) or **Multi-step** (e.g., **Gross profit**, **Income from ops**).

5. Closing Journal Entries

Goal: reset **temporary** accounts (revenues, expenses, dividends) to zero for the next period.

Permanent accounts (assets, liabilities, equity) carry forward.

Examples:

- Close revenues: DR Revenues, CR Income Summary (or RE).
- Close expenses: DR Income Summary (or RE), CR Expenses.
- Close dividends: DR Retained Earnings, CR Dividends.

Result: post-closing trial balance includes only **permanent** accounts.

6. Debt-Paying Ability (preview)

Ratio	Purpose	Rule of thumb
Net Working Capital	Liquidity buffer (CA – CL)	Positive is safer

Ratio	Purpose	Rule of thumb
Current Ratio	Ability to pay current liabilities	Around 1.50 is strong
Debt Ratio	Overall leverage	Lower is safer

Transaction effects: higher revenue / lower costs improve liquidity and NI; issuing shares raises cash & equity; borrowing less reduces liabilities.

7. Patterns & Trends (visual thinking)

Bar charts and line charts help compare companies and detect trends over time.

Example narrative: Fulton Hotels' **current ratio** stands out as the highest among peers; its ratio trends upward over five years with a slight dip in 20X4.

Worked Examples (GCD-style)

Example A — Cash vs Accrual Net Income (Exercise 3-13 style)

Data: revenues earned = 500,000; cash collected = 410,000; expenses incurred = 420,000; cash paid = 400,000.

Accrual NI: $500,000 - 420,000 = 80,000$.

Cash-basis NI: $410,000 - 400,000 = 10,000$.

Interpretation: accrual better reflects performance because it recognizes events when they occur, not just cash timing.

Example B — Recognition checks (Revenue & Matching)

- 1) Delivered goods today, payment next month: **Recognize revenue** now; **A/R up**.
- 2) Inventory purchased on account, not yet sold: **No COGS** yet; **Inventory up** and **A/P up**.
- 3) Sold item; cost known: **Recognize COGS** in the same period as sale.

Example C — Adjusting entries roundup (Exercise 3-20 flavor)

- Accrued interest expense 9,000: DR Interest Expense 9,000; CR Interest Payable 9,000.
- Accrued interest revenue 3,000: DR Interest Receivable 3,000; CR Interest Revenue 3,000.
- Unearned revenue earned (half of 12,000 for one delivered car): DR Unearned Revenue 6,000; CR Sales Revenue 6,000.
- Salaries accrued (Dec 30-31, 1,000/day, Tue-Fri pay cycle): DR Salaries Expense 2,000; CR Salaries Payable 2,000.
- Supplies used (on hand 800, unadjusted 3,100): DR Supplies Expense 2,300; CR Supplies 2,300.
- Depreciation (60,000 cost, 5 years, no residual): DR Depreciation Expense 12,000; CR Accumulated Depreciation 12,000.

Carrying amount after year 1: $60,000 - 12,000 = 48,000$.

Example D — Statement order and flow

- 1) IS → compute NI.
- 2) RE → $\text{Beg RE} + \text{NI} - \text{Div} = \text{End RE}$.
- 3) BS → Equity shows **End RE** (plus share capital).

Check headings: IS & RE are **for the year ended**; BS is **as at** date.

Quick Checks (Self-Test)

- Which basis recognizes **revenue on delivery even if unpaid**? → **Accrual**.
- What **two** accounts must every adjusting entry touch? → one **income statement** (R/E) and one **balance sheet** (A/L).

- Why is BS prepared last? → it needs **End RE** from RE.
- What gets closed? → **Revenues, Expenses, Dividends** (temporary). What does **not**? → **Assets, Liabilities, Equity** (permanent).

One-Page Reference

Topic	Key idea
Accrual vs Cash	Events vs cash timing; IFRS/ASPE require accrual
Revenue recognition	Deliver, measure reliably, probable receipt
Matching	Recognize costs with the related revenues
Adjusting	Deferrals, accruals, depreciation; R/E with A/L
Order of FS	IS → RE → BS (SCF later)
Closing	Close temporary; keep permanent
Ratios	NWC, Current Ratio, Debt Ratio (preview)