Accrual Accounting | Cash Basis
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Record revenue when work is done | Record revenue when Cash is received
Match an expense to when it helped to generate revenue | Match an expense to when Cash is paid

Main Point – In Accrual accounting, we IGNORE CASH when deciding whether or not to record a transaction. Why? Cash can be paid either before, during or after but we are interested in what the company is doing for this purpose, not its collection policy or payment policy of cash. Don’t worry, accountants have other measures for that stuff….explain later…

Revenue Recognition

1. Recognize revenue in the period when it is earned
2. Recognize revenue in the period service is provided or goods are sold
3. Disregard timing of cash payment when determining whether to recognize revenue

Expenses – Matching Principle

1. Recognize expense in the period it incurred to generate revenue
2. Recognize expense when asset used, time passes on loan, employees work
3. Disregard timing of cash payment when determining whether to recognize expenses

Revenue Recognition Rule

<table>
<thead>
<tr>
<th>Accounting Events</th>
<th>Recognize revenue?</th>
</tr>
</thead>
<tbody>
<tr>
<td>prepay for tutoring</td>
<td>NO</td>
</tr>
<tr>
<td>perform tutoring which was prepaid</td>
<td>Yes</td>
</tr>
<tr>
<td>provide tutoring and collect</td>
<td>Yes</td>
</tr>
<tr>
<td>perform tutoring, but don’t collect</td>
<td>Yes</td>
</tr>
<tr>
<td>collect for previous tutoring</td>
<td>NO</td>
</tr>
</tbody>
</table>

RULE: Recognize revenue when service is performed, ignore cash timing
Matching Principle

<table>
<thead>
<tr>
<th>Accounting events</th>
<th>Match Expense?</th>
</tr>
</thead>
<tbody>
<tr>
<td>prepay employees</td>
<td>NO</td>
</tr>
<tr>
<td>employees do work</td>
<td>Yes</td>
</tr>
<tr>
<td>employees work and are paid</td>
<td>Yes</td>
</tr>
<tr>
<td>employees do work, but you don’t pay them</td>
<td>Yes</td>
</tr>
<tr>
<td>pay the employees</td>
<td>NO</td>
</tr>
</tbody>
</table>

RULE: Match expense to when work is done, not when paid for (Ignore cash)

Four types of adjusting entries involve one I.S and one B.S. account

<table>
<thead>
<tr>
<th></th>
<th>Asset</th>
<th>Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>Accruing uncollected revenue</td>
<td>Converting Liability to Revenue</td>
</tr>
<tr>
<td>Expense</td>
<td>Converting asset to expense</td>
<td>Accruing unpaid expenses</td>
</tr>
</tbody>
</table>

Debit/Credit Rules for Each Type

<table>
<thead>
<tr>
<th></th>
<th>Asset</th>
<th>Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>Credit revenue account, debit receivable account</td>
<td>Debit Liability, Credit Revenue</td>
</tr>
<tr>
<td>Expense</td>
<td>Debit expense, Credit Asset</td>
<td>Debit Expense, Credit liability</td>
</tr>
</tbody>
</table>

Effects on Income Statement and Balance Sheet

<table>
<thead>
<tr>
<th>Adjustment</th>
<th>Income Statement</th>
<th>Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Revenue</td>
<td>Expenses</td>
</tr>
<tr>
<td>Converting Assets to Expenses</td>
<td>No effect</td>
<td>Increase</td>
</tr>
<tr>
<td>Converting Liabilities to Revenue</td>
<td>Increase</td>
<td>No effect</td>
</tr>
<tr>
<td>Accruing Unpaid Expenses</td>
<td>No effect</td>
<td>Increase</td>
</tr>
<tr>
<td>Accruing Uncollected Revenue</td>
<td>Increase</td>
<td>No effect</td>
</tr>
</tbody>
</table>

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After making our adjusting entries, we prepare the adjusted trial balance and use it to make the financial statements. With the following steps:

1. **Income statement**
   a. Use revenue and expense accounts

2. **Statement of retained earnings**
   a. Use retained earnings and dividends from adjusted trial balance
   b. Use Net Income from income statement

3. **Balance sheet**
   a. Use assets, liabilities and equity accounts from adjusted trial balance
   b. Use new retained earnings amount found from step 2

4. **Make statement of cash flows**

**Statement of Retained Earnings Formula**

\[
\text{Beginning Retained Earnings} + \text{Net Income} - \text{Dividends} = \text{Ending Retained Earnings}
\]

**Principle of Adequate Disclosure:** Disclose any facts necessary to interpret statements properly

**Examples of items to disclose**

- Pending lawsuits
- Scheduled plant closings
- Government investigations of company
- Significant events occurring after balance sheet date but before issuing statements
- Customer accounts > 10% of company revenue
- Unusual transactions/conflicts of interest between company and key officers

**Closing Process Rules**

1. Revenue (credit balances) closed to Income Summary
2. Expenses (debit balances) closed to Income Summary
3. Income Summary closed to Retained Earnings
4. Dividends closed directly to Retained Earnings

**Temporary Accounts are R.E.D**

- Revenue
- Expenses
- Dividends
These accounts are closed because we only want their values for a specific period. For example, we would want to know the revenue for the year, not since day 1 of operation.

Next step is to prepare post-closing trial balance

Accounting cycle steps

1. Analyze transactions
2. Journalize
3. Post
4. Prepare unadjusted trial balance
5. Adjusting entries
6. Prepare adjusted trial balance
7. Prepare financial statements
8. Closing transactions
9. Prepare post-closing trial balance
10. Reverse (optional)
11.

Definitions: 

**Adequate Disclosure**: GAAP process of providing information financial statement users would find relevant. It includes accounting methods, lawsuits, dates of major obligations. Not applicable to immaterial or optimistic forecasts.

**After-closing trial balance**: Prepared after all closing entries made. It only has balance sheet accounts.

**Closing Entries**: Used to close temporary accounts and transfer balances to retained earnings. Do NOT affect cash account, prepared before post-closing trial balance.

**Current Assets**: Cash and other assets easily converted to cash in less than 1 year. Examples include accounts receivable, inventory and prepaid expenses.

**Current Liabilities**: Obligations typically due in less than 1 year. Examples include accounts payable, notes payable and short term debt.

**Current Ratio**: A measure of liquidity calculated as current assets/current liabilities.

**Income Summary**: Summary account in ledger where revenue and expense accounts are closed. Credit balance = Net Income, Debit balance = Net Loss. It is transferred to Retained Earnings.

**Interim Financial Statements**: Financial statements for periods less than 1 year.

**Notes to financial statements**: Disclosures of extra relevant information to users of financial statements. Examples include pending lawsuits and due dates of major obligations.

**Worksheet**: Multicolumn schedule showing relationships among current account balances, proposed adjusting entries and resulting financial statements. It includes Trial balance, adjusting entries, and adjusted trial balance but NO transactions. It is a tool to help the accountant.