

Hello everyone! My name is Jerry and I am the Master Tutor for Financial Accounting! This semester I will be creating resources for you as you progress through Accounting 2303. These resources will be a breakdown of the material that you see in class each week based on several commonly asked questions. These questions will address theory. I will leave a little room for practical examples at the end. Additionally, I will be providing Accounting group tutoring sessions from 6:30-7:30pm over Microsoft Teams. If you would like to attend those sessions or want to schedule a 1-on-1 appointment with one of our fantastic accounting tutors, please visit [www.baylor.edu/tutoring](http://www.baylor.edu/tutoring) to make an appointment!

-Jerry

### Accounting 2303 Chapter 3 Part 1 Cash vs Accrual Accounting:

#### What is the difference between cash accounting and accrual accounting?

There are two methods of accounting that vastly differ in their treatment of transactions and their impact on the financial statements.

**Cash Accounting:** A method of accounting that only records cash-based transactions or when cash actually changes hands. This method is used by the smallest businesses and results in incomplete financial statements.

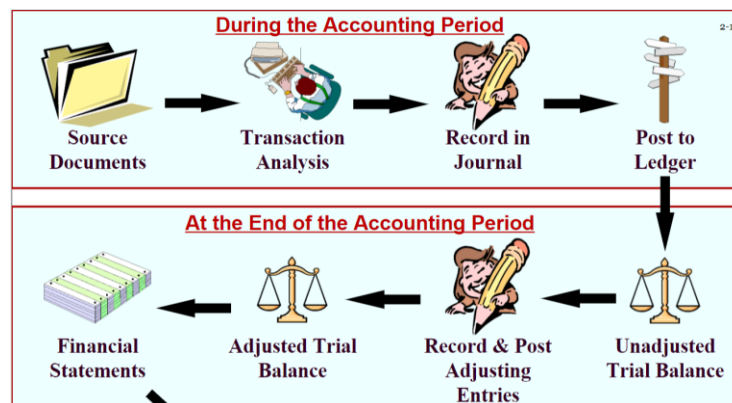
**Accrual Accounting:** A method of accounting that records the impact of any type of transaction **when that transaction occurs**. This method is required by US GAAP. The hallmark of accrual accounting is that it recognizes revenues and expenses **when they occur** as opposed to waiting until cash changes hands. This method will be the focus of the course.

The following video, created by Michael McLaughlin of Edspira.com, is another great resource if you want to learn more about the theory behind cash and accrual accounting.

[https://www.youtube.com/watch?v=Of2tFsfKm\\_8](https://www.youtube.com/watch?v=Of2tFsfKm_8)

#### What does accrual accounting do and how does it work?

Accrual accounting is all about recording transactions as they happen. As such, accountants report financial information at regular intervals. This is illustrated in the following graphic:



(Source: Pearson Education)

In other words, accrual accounting uses the revenue recognition and expense matching principle to record an initial transaction. As time goes on, adjusting journal entries are performed to reflect cash finally being received, an obligation being fulfilled, or a prepaid asset being used up.

### What are the Revenue Recognition and the Expense Matching Principles?

**Revenue Recognition:** Revenue is recognized when it is earned. Examples of this include when a firm transfers promised goods and services to company in exchange for compensation.

**Expense Matching principle:** Expenses are recorded in the same period in which any corresponding revenue is recognized (ie expenses are **matched** to revenues).

### What are Adjusting Entries, What Do They Do, and How Are They Recorded?

Adjusting entries account for the passage of time and they allow expenses and revenues to be matched in a given period. These journal entries always include one revenue and expense account and one asset or liability account. They **NEVER** include cash. The two main types of adjusting journal entries are deferrals and accruals.

**Deferrals:** These entries provide an adjustment when cash is received in advance or when a firm pays for something in advance. In other words, cash changes hands before the adjusting entry. The most common form of deferral entries are prepaid expenses or unearned revenues.

Example JE format:

#### Prepaid Expenses

*First – Pay cash and record an asset:*

<b>Prepaid Expense</b>	<b>XXX</b>	
<b>Cash</b>		<b>XXX</b>

*Later – Record an expense and decrease the asset:*

<b>Expense</b>	<b>XXX</b>	
<b>Prepaid Expense</b>		<b>XXX</b>

OR:

#### Unearned Revenues

*First – Receive cash and record unearned revenue:*

<b>Cash</b>	<b>XXX</b>	
<b>Unearned Revenue</b>		<b>XXX</b>

*Later – Record revenue and decrease unearned revenue:*

<b>Unearned Revenue</b>	<b>XXX</b>	
<b>Revenue</b>		<b>XXX</b>

(Source: Pearson Education)

**Accruals:** An adjustment made to accounts before a receipt or payment of cash. In other words, expenses and revenues are recorded before cash changes hand

Example JE format:

### ACCRUALS—Cash Later

#### Accrued Expenses

*First – Accrue expense and a payable:*

**Expense**                      **XXX**  
**Payable**                                      **XXX**

*Later – Pay cash and decrease the payable:*

**Payable**                      **XXX**  
**Cash**    **XXX**

OR

#### Accrued Revenues

*First – Accrue revenue and a receivable:*

**Receivable**                      **XXX**  
**Revenue**                                      **XXX**

*Later – Receive cash and decrease the receivable:*

**Cash**                                      **XXX**  
**Receivable**                                      **XXX**

(Source: Pearson Education)

Each of the adjusting entries and their corresponding accounts are summarized in the following chart:

Category of Adjusting Entry	Type of Account	
	Debit	Credit
Prepaid expense.....	Expense	Asset
Depreciation.....	Expense	Contra asset
Accrued expense.....	Expense	Liability
Accrued revenue.....	Asset	Revenue
Unearned revenue.....	Liability	Revenue

(Source: Pearson Education)

#### Examples:

##### Revenue and Expense Recognition:

On January 1<sup>st</sup>, Bob pays you \$1000 to mow his lawn every month for the next year. You are supposed to start mowing his lawn Feb 1. When will you record the revenue?

A: February 1. You do not recognize revenue until you fulfill your obligation. This is a classic example of a deferral.

Follow Up: If you were Bob, when would you record the expense?

A: February 1. One records expense when they are incurred.

### **Accrual Adjusting Entry Example:**

Your business makes custom tote bags. In February, you make \$1,200 worth of tote bags for a client, and then you invoice them. The client pays the invoice on March 7.

Record the Original JE:

2/27/2020 DR: Accounts Receivable \$1,200 CR: Revenue \$1,200

Adjusting Entry:

3/7/2020 DR: Cash \$1,200 CR: \$1,200

(Source: Bryce Warnes of bench.com)

### **Deferral Adjusting Entry Example:**

Suppose Baylor paid \$3,000,000 to the rent the Ferrell Center from January-March on January 1<sup>st</sup>. What are the journal entries on January 1<sup>st</sup> and January 31<sup>st</sup>?

1/1/2020 DR: Prepaid Rent \$3,000,000 CR: Cash \$3,000,000

1/31/2020 DR: Rent Expense \$1,000,000 CR: Prepaid Rent \$1,000,000

### **Further Examples:**

See the following videos for more help on adjusting entries, accruals, and deferrals:

<https://www.youtube.com/watch?v=KyjAU-yS4Lk&feature=youtu.be> (Adjusting journal entry theory)

[https://www.youtube.com/watch?v=C17Oc9JqG\\_Q&feature=youtu.be](https://www.youtube.com/watch?v=C17Oc9JqG_Q&feature=youtu.be) (Deferrals)

<https://www.youtube.com/watch?v=xXeoGIQOV1c> (Accruals)

### **Parting Words:**

- Accounting is like learning a language so vocabulary and practicing journal entries is important to your success
- Learn the general types of journal entries rather than memorizing every different scenario so that you don't get overwhelmed with the amount of information and can apply them to different situations
- Make an appointment in the tutoring center or come to group tutoring if you would like any help. We'd love to work with you!

### **Works Cited**

Financial Accounting by Harrison, Horngren, and Thomas, 12th Edition, Prentice Hall via Pearson Education 2015

Edspira.com

<https://bench.co/blog/bookkeeping/adjusting-entries/>