Accruals and Prepayments

A complete last-minute revision map: the four accrual/prepayment classifications, the period-end adjusting formulas, journal entries, and the financial statement effect — exactly as tested in PRC-1.

Accrual Concept | 4-Way Classification | Adjusting Formulas | Year-End Journal Entries

1 CORE CONCEPT

> *Under the accrual (matching) concept, income and expenses are recognised in the period they are earned or incurred — not simply when cash is received or paid.*

This means cash paid or received during the year must be adjusted for amounts relating to a different period, using opening and closing accrual/prepayment balances.

2 KEY DEFINITIONS — THE FOUR CLASSIFICATIONS

LIABILITY
Accrued Expense
Expense incurred but not yet paid — owed at year end (e.g. unpaid utility bill).

ASSET
Prepaid Expense
Expense paid in advance, not yet incurred — a future benefit (e.g. insurance paid ahead).

ASSET
Accrued Income
Income earned but not yet received — owed to the business at year end.

LIABILITY
Unearned / Deferred Income
Cash received in advance for income not yet earned — an obligation to deliver.

3 IMPORTANT ACCOUNTING RULES — MATCHING CASH TO THE PERIOD

✓ Belongs to THIS period

Opening prepayment
Now consumed — add to this year's expense

Closing accrual
Incurred but unpaid — add to this year's expense

Opening unearned income
Now earned — add to this year's income

Closing accrued income
Earned but unreceived — add to this year's income

✗ Belongs to ANOTHER period

Opening accrual
Relates to last year — deduct from cash paid

Closing prepayment
Relates to next year — deduct from cash paid

Opening accrued income
Relates to last year — deduct from cash received

Closing unearned income
Relates to next year — deduct from cash received

4 FORMULAS

EXPENSE FOR THE YEAR

```
Cash Paid
− Opening Accrual
+ Closing Accrual
+ Opening Prepayment
− Closing Prepayment
```

INCOME FOR THE YEAR

```
Cash Received
− Opening Accrued Income
+ Closing Accrued Income
+ Opening Unearned Income
− Closing Unearned Income
```

5 ACCOUNTING TREATMENT — YEAR-END ADJUSTING ENTRIES

RECORD AN ACCRUED EXPENSE

```
Dr  Expense
   Cr  Accrued Expense (Liability)
```

RECORD A PREPAID EXPENSE

```
Dr  Prepaid Expense (Asset)
   Cr  Expense
```

RECORD ACCRUED INCOME

```
Dr  Accrued Income (Asset)
   Cr  Income
```

RECORD UNEARNED / DEFERRED INCOME

```
Dr  Income
   Cr  Unearned Income (Liability)
```

6 STEP-BY-STEP ROADMAP

1. **Start with cash paid / received**
   The actual amount that moved during the year.
2. **Remove the opening balance's effect**
   It belongs to last year — reverse it out.
3. **Add the closing balance's effect**
   It belongs to this year even though cash hasn't moved yet.
4. **The result is the true expense/income**
   This is what appears in the income statement.

8 LEDGER TREATMENT — EXPENSE ACCOUNT MOVEMENT

EXPENSE ACCOUNT (e.g. Rent)	
DEBIT (Dr)	**CREDIT (Cr)**
Opening Prepayment b/d	Opening Accrual b/d
Cash Paid during the year	Transfer to Income Statement (P&L)
Closing Accrual c/d	Closing Prepayment c/d

The **balancing figure** transferred to the income statement is the true expense for the year.

9 FINANCIAL STATEMENT EFFECT

- **Accrued expense / Unearned income**
  Shown as a CURRENT LIABILITY in the SOFP
- **Prepaid expense / Accrued income**
  Shown as a CURRENT ASSET in the SOFP
- **Income statement**
  Always shows the MATCHED figure, not the cash figure

10 COMMON EXAM CASES — DECISION TREE

IF expense paid in advance	→ Prepaid expense — current ASSET
IF expense incurred, unpaid	→ Accrued expense — current LIABILITY
IF income received in advance	→ Unearned income — current LIABILITY
IF income earned, unreceived	→ Accrued income — current ASSET

11 COMMON MISTAKES / EXAM TRAPS

Trap: Swapping accrual and prepayment
An accrual is what you STILL OWE (liability); a prepayment is what you've PAID AHEAD (asset). Read "paid in advance" vs "not yet paid" carefully.

Trap: Confusing accrued income with unearned income
Accrued income is money OWED TO the business (asset); unearned income is money the business OWES a service for (liability) — opposite directions.

Trap: Getting the +/− signs backwards
Opening balances reverse OUT (they belong to last year); closing balances add IN (they belong to this year) — mixing this up gives the wrong expense/income.

Trap: Forgetting the closing balance carries forward
The closing accrual/prepayment becomes next year's OPENING balance — it must reverse through the same formula again next period.

★ QUICK EXAMPLE

SCENARIO
A rent account shows: opening prepayment Rs. 15,000, cash paid Rs. 220,000, and closing accrual Rs. 10,000 (the account moved from prepaid to accrued during the year).

CALCULATION

```
Expense = Cash Paid + Opening Prepayment + Closing Accrual
= 220,000 + 15,000 + 10,000
```

RESULT
Rent expense for the year = **Rs. 245,000** — both adjustments add IN because the opening prepayment is now consumed, and the closing accrual is incurred but unpaid.

FOUR CLASSIFICATIONS
Accrued expense & unearned income = liabilities. Prepaid expense & accrued income = assets.

EXPENSE FORMULA
Cash Paid − Opening Accrual + Closing Accrual + Opening Prepayment − Closing Prepayment.

INCOME FORMULA
Cash Received − Opening Accrued Income + Closing Accrued Income + Opening Unearned − Closing Unearned.

GOLDEN RULE
Opening balances reverse OUT; closing balances add IN. The result matches income/expense to the correct period.