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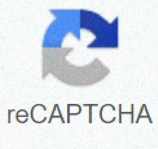
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What is a accounts payable accrual

It’s a common interview question! You may be asked about the differences between them, how changes are reflected on the 3 financial statements, and so on. And most Google search results on this topic are AWFUL and do not answer the actual question at all, or do so in a confusing way that misses the point (trust me, I looked). THE SHORT ANSWER: Accounts Payable (AP) and Accrued Expenses (AE) work in a VERY similar way… IF they both correspond to Operating Expense line items, or other items that appear directly on the Income Statement. However, AP is more likely to correspond to events such as the purchase of Inventory, which would NOT show up on the Income Statement initially, and so you’re more likely to see different treatment with Accounts Payable (no Income Statement impact – just an Asset on the Balance Sheet increasing and AP on the Liabilities & Equity side increasing to balance the change). Both these items represent cases where we’ve INCURRED an expense but not actually paid for it in cash yet. Example 1: We get an invoice for a legal bill from a law firm we hired. They already performed the service, so we incurred the expense, but we haven’t paid them in cash yet. Example 2: We pay rent at the beginning of each month. In between, that expense accrues because we use the building or office every day of the month… so it’s not accurate just to view it as an expense on one day of the month, but rather an expense that gets accrued every single day and then paid in cash at the beginning of the month. Example 1 corresponds to Accounts Payable, because we typically use AP for items with specific invoices. Example 2 corresponds to Accrued Expenses, which we typically use for recurring, monthly/quarterly/weekly items WITHOUT specific invoices, such as rent, utilities, employees’ wages, and so on. Master Financial Modeling As It Is Performed In Real Life, With Our Simple 3-Step Method FREE INSTANT ACCESS Master Financial Modeling, As It Is Performed In Real Life. What Happens on the 3 Statements When AP or AE Change? IF they both correspond to COGS or Operating Expenses IN THE CURRENT PERIOD and therefore refer to actual expenses listed on the Income Statement: Let’s use the example of AP or AE of $100 on the 3 statements: 1) Income Statement – Expenses (most likely OpEx) will increase by $100, reducing Pre-Tax Income by $100 and Net Income by $60 assuming a 40% tax rate. 2) Cash Flow Statement – Net Income is down by $60, but this expense we just recognized was non-cash, so we record the increase in AP or AE as a cash increase of $100. Our cash flow and ending cash at the bottom are up by $40. 3) Balance Sheet – Cash is up by $40 on the Assets side; on the L&E side, AP or AE is up by $100, but Retained Earnings is down by $60 due to the reduced Net Income, so both sides are up by $40. INTUITION: You’ve saved on taxes because you recorded an expense, took the tax deduction, and reduced your tax bill… but you haven’t paid that expense in cash yet! It’s all about the tax savings in this first step. Now, Step 2: What Happens When You Pay the AP or AE in Cash, For Real 1) No changes on the Income Statement – already recognized this as an expense! 2) Cash Flow Statement: Net Income is still down by $60… and now we REMOVE that adjusting entry for AP or AE, so cash no longer goes up by $100 from that. As a result, cash at the bottom is just down by $60. 3) Balance Sheet: Cash is now down by $60 rather than being up by $40, because we just paid that expense in cash. On the other side, AP or AE is now back to its old level and is no longer up by $100. Retained Earnings is still down by $60, so both sides are down by $60 and balance. BUT HERE’S THE IMPORTANT DIFFERENCE BETWEEN THEM: AE almost always correspond to Operating Expenses or other Income Statement expense items… but Accounts Payable often do not. EXAMPLE: Company buys $100 of Inventory on credit – supplier sends over the Inventory, “in good faith,” and sends the company an invoice, which goes to its Accounts Payable account. In this case, there are NO CHANGES on the Income Statement because nothing happens there until this Inventory is turned into products and sold to customers! Instead, Inventory on the BS simply goes up by $100, and AP on the other side goes up by $100 to balance it. That scenario happens a lot with AP, but very-rarely-to-never with AE. In financial accountingFinancial Accounting TheoryFinancial Accounting Theory explains the why behind accounting - the reasons why transactions are reported in certain ways. This guide will, accruals refer to the recording of revenuesSales RevenueSales revenue is the income received by a company from its sales of goods or the provision of services. In accounting, the terms "sales" and that a company has earned but has yet to receive payment for, and the expensesFixed and Variable CostsCost is something that can be classified in several ways depending on its nature. One of the most popular methods is classification according that have been incurred but that the company has yet to pay. The method follows the matching principle, which says that revenues and expenses should be recognized in the same period for which they were incurred.Such accounting practices, therefore, have a general impact on the handling of the income statement and the balance sheet. The affected accounts include accounts payableAccounts PayableAccounts payable is a liability incurred when an organization receives goods or services from its suppliers on credit. Accounts payables are, liabilities and non-cash-based assets, goodwill, future tax liabilities, and future interest expenses, among others.What is an Accrual (in plain English)?What exactly is an “accrual”? If companies received cash payments for all revenues at the same time when they were earned, and made cash payments for all expenses at the time when they were incurred, there wouldn’t be a need for accruals. However, since most companies have some revenues in the year that were earned (i.e., good/services were delivered) but for which payment was not received, they need to account for those unpaid revenues.The same applies to expenses. If companies incurred expenses (i.e., received goods/services) but didn’t pay for them with cash yet, then they need to be accrued.The purpose of accrual accounting is to match revenues and expenses to the time periods during which they were incurred, as opposed to the timing of the actual cash flows related to them.Categories in Accrual AccountingIn accounting, accruals in a broad perspective fall under either revenues (receivables) or expenses (payables).1. Accrued RevenuesAccrued revenues are either income or assets (including non-cash assets) that are yet to be received. In this case, a company may provide services or deliver goods, but does so on credit.ExampleAn example of accrued revenue is electricity consumption. An electricity company usually provides the utility to its consumer prior to receiving payment for it. The consumer uses the electricity and the meter counts the reading. Then, at the end of the billing period, the consumer is billed. During the month, the company pays its employees, it fuels its generators, and it incurs logistical costs and other overheads.The electricity company needs to wait until the end of the month to receive its revenues, despite the during-the-month expenses that it has. Meanwhile, it must acknowledge that it expects future income. Accrual accounting, therefore, gives the company a means of tracking its financial position more accurately.At the end of the month, when the company receives payment from its debtors (customers), receivables go down, while the cash account increases.2. Accrued ExpensesAn accrued expense refers to when a company makes purchases on credit and enters liabilities in its general ledger, acknowledging its obligations to its creditors. In accounting, it is an expense incurred but not yet paid. Common accrued expenses include:Interest expense accruals – Interest expenses that are owed but unpaid.Suppliers accruals – Operating expenses for goods or services rendered by a third-party supplier.Wage or salary accruals – These include salaries owed to employees who work for part of the month without having received their full earned monthly salary.ExampleLet’s take an example of a start-up company (Y) with an employee (Joe) who is under a cliff vesting plan, and who is also getting a vesting schedule incentive after five years of commitment. Joe becomes faithful, hardworking, and diligent in the course of working for the company. He makes it through the first year and thus receives his cliff vesting bonus, and qualifies for the subsequent five years of the rest of his vesting schedule bonuses.However, during this period, Joe is not receiving his bonuses materially, as would be the case with cash received at the time of the transaction. Instead, Joe’s bonuses have been accruing. Parallel to that, Company Y’s liabilities have also been increasing.In this case, it’s obvious that Company Y becomes a debtor to Joe for five years. Therefore, to carry an accurate recording of Joe’s bonuses, the company must make a bonus liability record to record these bonus expenses. When the company pays out Joe’s owed bonuses, the transaction will be recorded by the company debiting its liability account and crediting its cash account.Prepaid Expenses vs. Accrued ExpensesPrepaid expenses are the payment opposite of accrued expenses. Rather than delaying payment until some future date, a company pays upfront for services and goods, even if it does not receive the total goods or services all at once at the time of payment. For example, a company may pay for its monthly internet services upfront, at the start of the month, before it actually uses the services.Impact of Accrual AccountingIn addition to accruals adding another layer of accounting information to existing information, they change the way accountants do their recording. In fact, accruals help in demystifying accounting ambiguity relating to revenues and liabilities. As a result, businesses can often better anticipate revenues while keeping future liabilities in check.Accruals assist accountants in identifying and monitoring potential cash flow or profitability problems and in determining and delivering an adequate remedy for such problems.Recording AccrualsTo record accruals, the accountant must use an accounting theory known as the accrual method. The accrual method enables the accountant to enter, adjust, and track “as yet unrecorded” earned revenues and incurred expenses. For the records to be usable in the financial statement reports, the accountant must adjust journal entries systematically and accurately, and they must be verifiable.The Relationship between Accrual Accounting and Cash AccountingEven though both accrual accounting and cash accounting methods serve as a yardstick of performance and the economic position of a company in a given fiscal year, financial transactions in accrual accounting are reported as they happen – both debits and credits. However, the recording of transactions in cash accounting occurs at the time of cash transactions.FASB and IFRS ExampleThe Financial Accounting Standards Boards (FASB) has set out Generally Accepted Accounting Principles (GAAP) in the U.S. dictating when and how companies should accrue for certain things. For example, “Accounting for Compensated Absences” requires employers to accrue a liability for future vacation days for employees. Learn more about this example on FASB’s website.International companies outside the U.S. follow IFRS standards. To learn more, visit their website.Additional ResourcesCFI is the official global provider of the Financial Modeling and Valuation Analyst (FMVA)® Become a Certified Financial Modeling & Valuation Analyst (FMVA)®CFI's Financial Modeling and Valuation Analyst (FMVA)® certification will help you gain the confidence you need in your finance career. Enroll today!designation, a leading financial analyst certification program. To continue learning and advancing your financial career, these additional CFI resources will be helpful:Adjusting EntriesAdjusting EntriesThis guide to adjusting entries covers deferred revenue, deferred expenses, accrued expenses, accrued revenues and other adjusting journalDepreciation ExpenseDepreciation ExpenseWhen a long-term asset is purchased, it should be capitalized instead of being expensed in the accounting period it is purchased in.Projecting Income Statement Line ItemsProjecting Income Statement Line ItemsWe discuss the different methods of projecting income statement line items. Projecting income statement line items begins with sales revenue, then costProjecting Balance Sheet Line ItemsProjecting Balance Sheet Line ItemsProjecting balance sheet line items involves analyzing working capital, PP&E, debt share capital and net income. This guide breaks down how to calculate

what is accrued accounts payable

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