MODULE 1 · SESSION 1

Read Statements Through Accruals

How the three statements connect, and why the accrual entries behind them decide what the numbers actually mean.

Theory session

Intermediate

Running case: LedgerLift

ORIENTATION

Where this session sits

Module 1 establishes how financial information is constructed before anyone relies on it

MODULE 1
Build Reliable Financial Foundations

MODULE 2
Manage Cash and Uncertainty

MODULE 3
Choose and Manage Funding

SESSIONS IN THIS MODULE

1.1 **Read Statements Through Accruals** — YOU ARE HERE
Connecting the three statements to the entries that create them

1.2 Allocate Costs, Explain Margin
Assigning shared costs and reconciling margin movement

1.3 Control the Monthly Finance Close
Catching errors before decisions are made on them

SESSION OUTCOMES

What this session explains

Reading statements as the output of a recording system, not as given facts

01 **Accrual is a timing rule**

Revenue and expense are recorded when earned or incurred, not when cash moves.

02 **The three statements are one system**

Each is a different view of the same transactions, and they must reconcile.

03 **Estimates are policy choices**

An accrual embeds a judgement, and the judgement can be better or worse.

04 **Profit and cash diverge for identifiable reasons**

Every gap between them sits in a specific working-capital or non-cash line.

DEFINITION

What accrual accounting commits you to

One rule, applied consistently, with consequences in every statement

WORKING DEFINITION

Accrual accounting records revenue when it is earned and expense when it is incurred, regardless of when cash is received or paid — so the statements describe economic activity in a period rather than banking activity.

1

The matching principle

Costs are recognised in the same period as the revenue they helped generate — which is why cost allocation (Session 1.2) matters to the income statement.

2

Recognition, not receipt

An invoice raised and unpaid is revenue and a receivable. Cash received in advance is a liability, not revenue.

3

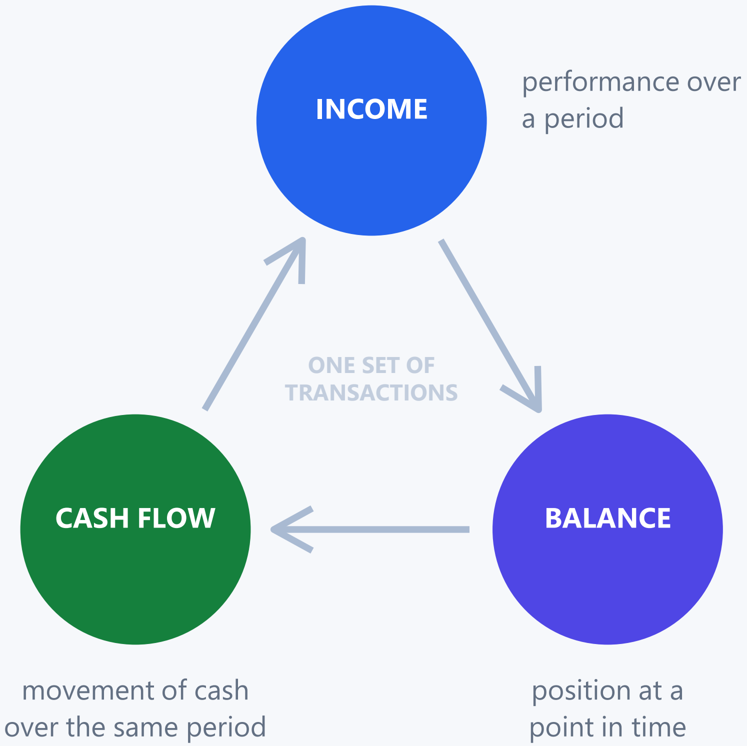
Estimates are unavoidable

Depreciation, bad debt, warranty and accrued expenses all require judgements made before the outcome is known.

IFRS Conceptual Framework (2018), Chapter 1; and IAS 1 on the accrual basis of accounting.

How the three statements lock together

They are not three reports; they are three views with mandatory connections



LINK ONE

Profit into equity

Net income for the period increases retained earnings on the balance sheet. If it does not tie, something is wrong.

LINK TWO

Cash into the balance sheet

The closing cash balance on the cash flow statement is the cash line on the balance sheet.

LINK THREE

Working capital moves

Changes in receivables, payables and inventory reconcile profit to operating cash — the indirect method.

From profit to operating cash

Every difference between the two sits in a line you can name

INDIRECT METHOD, ILLUSTRATIVE (£000)

A profitable period can produce negative operating cash when growth absorbs working capital.

NON-CASH ITEMS

Added back

Depreciation and amortisation reduced profit without moving cash, so they are reversed.

WORKING CAPITAL

Growth consumes cash

Rising receivables and inventory are cash spent and not yet returned. Rising payables are cash retained.

THE DIAGNOSTIC

Name the gap

“Profitable but short of cash” is never a mystery. It is one of these four lines.

Five accrual entries and what each one asserts

Each is a claim about timing that could be made differently

Entry	What it records	The judgement inside it
Accrued expense	A cost incurred but not yet invoiced by the supplier.	How much. The freight case is exactly this estimate.
Accrued revenue	Work performed but not yet billed to the customer.	Whether the performance obligation has genuinely been satisfied.
Deferred revenue	Cash received before the obligation is met.	Over what period it is released to the income statement.
Prepayment	Cash paid before the benefit is consumed.	The period over which it is expensed.
Provision	An obligation of uncertain timing or amount.	Whether it is probable, and how it is measured.

WHAT THEY HAVE IN COMMON

Every one of these moves profit between periods without moving cash. That is the point — and it is also why they are the first place to look when reported margin behaves strangely.

Two ways to build the same accrual

The freight case, generalised

PROXY-BASED

An average applied to a count

WHY IT IS USED

It is fast, needs no integration, and produces a defensible-looking number.

WHAT IT ASSUMES

That the population is homogeneous — that one shipment is much like another.

HOW IT FAILS

When the population varies, the estimate is wrong in both directions and the error does not cancel.

ACTIVITY-BASED

Rates applied to actual events

WHAT IT REQUIRES

A feed of operational activity and a rule that prices each event.

WHAT IT BUYS

An accrual that moves with the business, and visibility of the open liability.

THE COST

Integration work, and a rating rule someone must own and maintain.

HOW TO JUDGE THE METHOD

The test of an accrual method is not whether it produces a number. It is whether the difference between the estimate and the eventual invoice is small and unbiased.

Reading the quality of reported earnings

Four checks that take minutes and catch most problems

CASH CONVERSION	Is operating cash flow tracking net income over several periods, or drifting away from it?
RECEIVABLE DAYS	Are they rising faster than revenue? Revenue may be recognised earlier than it is collected.
ACCRUAL REVERSALS	Do last period's accruals keep reversing materially? The estimate is biased, not merely imprecise.
ONE-OFF ITEMS	How much of the result depends on entries that will not repeat?

Dechow, P. & Dichev, I. (2002). The quality of accruals and earnings. The Accounting Review, 77(s-1), 35–59.

THE PRINCIPLE

Accruals reverse

An aggressive estimate borrows profit from a future period. It does not create profit.

WHAT TO WATCH

Direction, not size

Estimates are wrong; that is expected. Consistently wrong in one direction is a different finding.

FOR A FOUNDER

Your own numbers first

These checks apply to your own management accounts before anyone else applies them to you.

Cash basis, accrual basis, and what each hides

Neither is the truth; each answers a different question

CASH BASIS

Simple and unambiguous. Tells you what moved. Hides obligations already incurred and revenue already earned.

ACCRUAL BASIS

Matches effort to result within a period. Requires judgement, and can be shaped by it.

BOTH, ALWAYS

Run the accrual statements for performance and a direct cash view for liquidity. Managing on one alone is how solvent companies fail.

WHICH QUESTION EACH ANSWERS

Question	Answered by
Did we trade profitably this month?	Accrual income statement.
Can we pay salaries on the 28th?	Direct cash forecast.
Is growth consuming more cash than it returns?	The profit-to-cash bridge.

Three reporting habits that mislead quietly

None of them is fraud; all of them produce decisions on bad information

The unchanged estimate

Looks like The same accrual amount, month after month.

Why it fails Activity changed; the estimate did not.

Fix Tie the estimate to a driver that moves.

Revenue ahead of delivery

Looks like Strong revenue, rising receivable days.

Why it fails Performance obligations may not be satisfied.

Fix Test recognition against delivery evidence, not the invoice date.

Managing on the P&L alone

Looks like A profitable, growing company running out of cash.

Why it fails Working capital absorption is invisible in the income statement.

Fix Review the bridge every month, not the profit line.

CASE STUDY

A freight accrual rebuild

An accrual estimate that was easy to calculate and wrong every month, replaced by one built from the activity that created the liability.

An estimate rebuilt from the activity that created it

The method changed; the accounting principle did not

THE OLD METHOD

Average × count

HOW IT WORKED

A simple average shipment cost multiplied by the number of shipments.

WHAT IT REMOVED

Lane-specific rates and product profiles — the two things that made shipments differ.

THE CONSEQUENCE

Major over-accruals and under-accruals every month, and no view of open freight liability.

THE REBUILD

Daily rated activity

DATA TIMING

Integration with the transport management system fed daily shipment activity into the accrual.

COST BASIS

A rating engine applied real tariffs and agreements instead of one blended average.

THE RESULT

Finance gained visibility into real-time open freight liabilities.

READING THE CASE

An accrual is an estimate of an obligation that already exists. Its quality depends on whether it is built from the operational facts that created the obligation.

Drawn from the session case pack.

APPLICATION

Bringing the theory to LedgerLift

A month-end reading routine that takes under an hour

Step	What you check	LedgerLift example
Tie the statements	Net income into equity; closing cash into the balance sheet.	Both agree, or the close does not proceed.
Build the bridge	Profit to operating cash, line by line.	£62k profit, negative £40k operating cash — receivables up £88k.
Review each accrual	Driver, amount, and last month's reversal.	Hosting accrual still at a flat £9k while usage rose 30%.
Check recognition	Is revenue matched to delivered obligations?	Annual contracts billed up front — released monthly, not on invoice.
Check the direction	Are estimates biased one way over three months?	Freight-style pattern: consistent under-accrual, then catch-up.

WHAT COMES NEXT

Session 1.2 takes the costs inside these statements and asks how they should be assigned.

SUMMARY

What to carry out of this session

1. **Accrual is a timing rule, not a truth claim.**
   It records when activity happened, which is a judgement someone made.

2. **The three statements must reconcile.**
   Profit into equity, closing cash into the balance sheet, working capital into the bridge.

3. **Build estimates from drivers, not from averages.**
   An average applied to a count assumes a homogeneity that rarely exists.

4. **Watch the direction of estimate error.**
   Imprecise is normal; consistently biased is a finding.

5. **Profit and cash diverge in nameable lines.**
   If you cannot name which line, you have not built the bridge.

Sources for this session

Primary references behind each concept

FRAMEWORK	IFRS Foundation (2018). *Conceptual Framework for Financial Reporting.*
PRESENTATION	IAS 1, *Presentation of Financial Statements*; IAS 7, *Statement of Cash Flows.*
REVENUE	IFRS 15, *Revenue from Contracts with Customers* (ASC 606 in US GAAP).
EARNINGS QUALITY	Dechow, P. & Dichev, I. (2002). The quality of accruals and earnings. *The Accounting Review*, 77(s-1), 35–59.
ANALYSIS	Penman, S. (2013). *Financial Statement Analysis and Security Valuation* (5th ed.). New York: McGraw-Hill.
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