LET'S GET TECHNICAL

My gardener grabbed me by the shrubs the other day. "I need £100 off you, Gareth," he said. "But I haven't had an invoice from you Tony!" I replied. "But I did the work last week. I've earned me money. I'm just not very good with me paperwork!" Little did Tony know that he was applying the accounting concept of accruals.

A couple of months ago I looked at dealing with accrued expenses. In this article I am going to look at dealing with accrued and deferred income.

In essence both are examples of the application of the accruals, or 'matching' concept. We must ensure that income is recognised in the period that the income is 'earned' (when you did the work that generated the income). It doesn't matter when the sale is paid for or when we send out the invoice.

If we earn some income by delivering goods to a customer (selling them some sugar, for example) and the customer pays for those goods immediately then the double entry is:
Dr Cash (the asset that we now own).
Cr Sales (the income that we have generated from delivering the goods).

This is a cash sale.

If we earn income by delivering goods to a customer and they do not pay immediately because we offer them a credit period we would normally send them an invoice as a request for payment at a later date. The double entry for this is:
Dr Sales ledger control account (the asset of the receivables balance owed by the customer).
Cr Sales (we have still generated income by delivering the goods even if we haven't been paid yet).

This is a credit sale. Note that it doesn't matter that we haven't been paid for the goods yet, we have delivered them to the customer so have 'earned' the income. This means that the credit is still made to the sales account.

Accrued and deferred income is fertile ground for Gareth John

Accrued income

Now, what if we deliver goods to a customer and they are not paying immediately but we haven't even issued an invoice yet (perhaps due to an administrative delay)? We still need to recognise the income we have earned as we have delivered the goods, but since there is no sales invoice to list in the sales day book there would be no entry made to the sales ledger control account. We therefore need to recognise another form of receivable that we will invoice and collect at some point in the future; accrued income.

The double entry for this is:
Dr Accrued income (again, an asset. Think of this as an 'uninvoiced receivable').
Cr Sales (again, still recognising the income generated as we have delivered the goods).

As long as we have delivered the goods we have 'earned' the income, it does not matter that we haven't sent an invoice.

Accrued income is a current asset and would sit on the balance sheet (the Statement of Financial Position) under trade receivables.

Eliminating accrued income

When you eventually raise the invoice for the goods that the customer has had you can eliminate the accrued income as follows:
Dr Sales ledger control account (now that you have raised an invoice).
Cr Accrued income (getting rid of our 'uninvoiced receivable' now that it has been invoiced).

Deferred income

If accrued income is where we have earned income but not yet been paid for it or sent an invoice to the customer, deferred income is the exact opposite; where we have been paid by a customer for something but haven't actually earned the income (we haven't delivered the goods yet). It would occur in a situation where a customer is paying in advance for goods that we are going to deliver in the future.

If we haven't delivered the goods yet then we haven't 'earned' the income so we cannot recognise anything in the sales account yet. Instead we recognise a liability called deferred income. It may seem strange that we are recognising a liability when we are dealing with a customer but if they pay in advance for goods then we owe them that money until we deliver the goods. If we fail to do so we will have to repay them the amount that they have paid.

The double entry is therefore:
Dr Cash (the payment we have received in advance from the customer).
Cr Deferred income (the liability we owe to the customer until we deliver their goods).

Note that we don't recognise anything in the sales account as although we have had some cash from the customer we haven't done the work that 'earns' this income.

Deferred income is a current liability and would sit on the balance sheet under trade payables.

Eliminating deferred income

When we deliver the goods to the customer, we have now done the work to 'earn' the income and will no longer have to potentially pay them back so the double entry posted is:
Dr Deferred income (to remove the liability no longer needed).
Cr Sales (as we have now 'earned' the income).

Other forms of income

In some tasks the 'income' being dealt with may be something other than sales of goods, for instance it may be rental income. The basic double entry here is much the same as above.

So, if a tenant has occupied some space we own (meaning that we have 'earned' the income) but we haven't yet invoiced them this is accrued income:
Dr Accrued income
Cr Rental income (instead of sales)

And if a tenant has paid in advance for next period it is deferred income as we haven't 'earned' the income yet:
Dr Cash
Cr Deferred income

Try this task and then watch me work my answers at www.firstintuition.co.uk/category/aat

We own a building in which we rent space to tenants at £1,000 per annum. One tenant pays for two years in advance and a second tenant will be invoiced for the same two years at the end of the second year. Show the relevant ledger accounts at the end of the first year. PQ

• **Gareth John is a tutor/director with First Intuition and helps to manage their AAT distance learning programme. He was PQ's Accountancy Lecturer of the Year in 2011**