

Bases of Accounting

Cash Basis and Accrual Basis

Objectives

After going through this lesson, you shall be able to understand the following concepts.

- Cash Basis of Accounting
- Accrual Basis of Accounting
- Difference between Accrual & Cash Basis

Cash Basis of Accounting

The cash basis of accounting recognises revenue and expenses at the time of actual receipt or payment of cash.

The cash basis of accounting is less accurate than accrual basis of accounting as they affect the company's books only when complete exchange of value has occurred. Cash basis of accounting might be easier and cheaper to maintain but the needs of users of financial statements are not satisfied due to inaccurate nature of this method.

Example

A construction company secures a contract for construction of a stretch of Delhi Metro and will receive the payment for the same from DMRC at the completion of construction. Using cash basis of accounting, revenue would be recognised only on the completion of the project, while the expenses will be recorded as and when they have been paid out.

Generally, projects take more than a year to complete; in such scenarios the income statement of the company would be misleading as the company will incur large losses in one year and abnormally high profits in the next year.

Advantages

- (a) Maintaining books under cash basis is comparatively easier and cheaper.
- (b) More rational approach as it is based on actual cash inflows and outflows.
- (c) A more suitable approach for entities with most of the transactions taking place in cash.

Disadvantages

- (a) Fails to exhibit the true and fair view of the financial performance and financial position as it ignores outstanding and prepaid expenses and unearned and accrued incomes.
- (b) This method is inconsistent with the matching principle of accounting.

(c) Cash basis of accounting allows easy manipulations of profits. To reflect a better financial position, payments may be delayed and amounts due may be collected before due dates and vice-versa.

Accrual Basis of Accounting

According to the accrual concept, revenue and cost are recognised as and when they occur instead of when they are actually paid or received in cash. The revenue is generated and the costs are incurred when the legal right to receive or obligation to pay is established.

Examples

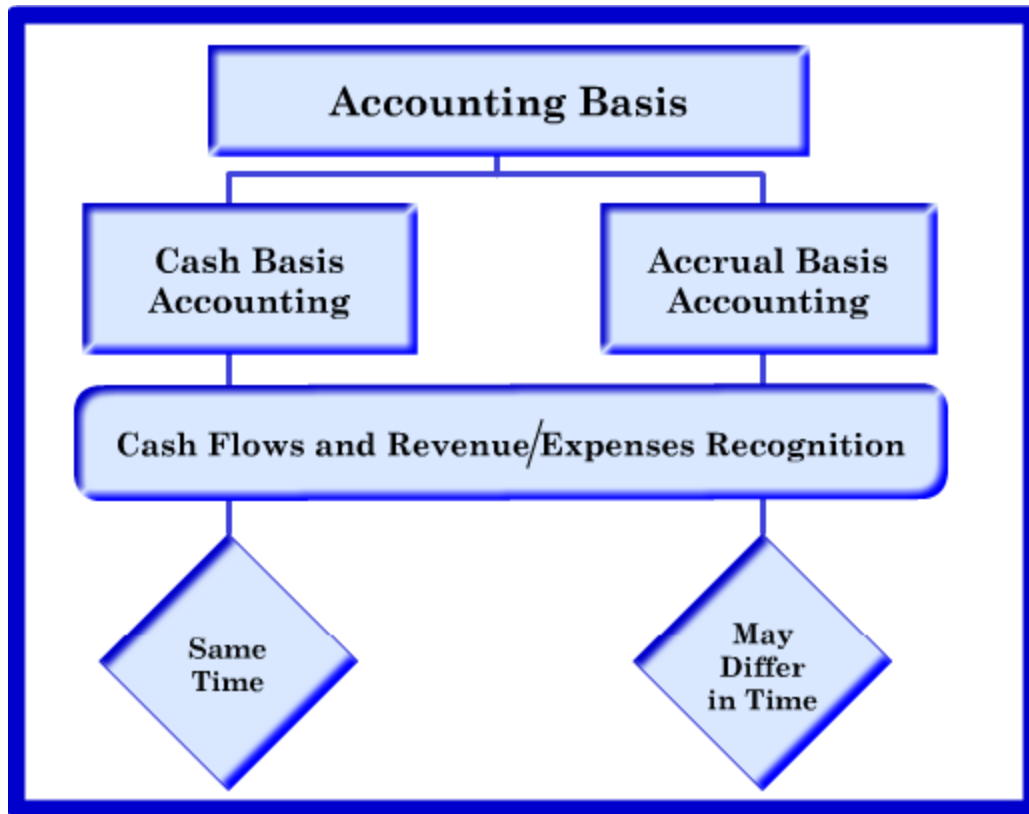
1. A Company records its electricity bills when it receives the bills, not when the payment is made, as electricity service has already been provided. In such a case, the company has to ignore the date on which the payment is being made.
2. A Mumbai based Law firm has obtained its premises on rent and has paid Rs 1,20, 000 on 1st October. The premises has not been put to use yet so it hasn't been recorded as expense. A half yearly report is prepared on 31st March, the firm expensed out six months' rent i.e. 60,000 [$\text{Rs } 1,20,000 / 12 \times 6$] because time equivalent to 6 months has expired.

Advantages

- (a) Exhibits true and fair view of the financial performance and financial position as it takes into account all the adjustments like outstanding and prepaid expenses and unearned and accrued incomes.
- (b) Based on matching principle of accounting.
- (c) Recognised by Companies Act, 2013

Disadvantages

- (a) Determination of profits and losses under this method is a cumbersome process.
- (b) This method is not free from personal bias.
- (c) Various estimations are required to be made under this method.



Difference between Accrual & Cash Basis

Basis Of Difference	Accrual Basis	Cash Basis
Preferred by	Businesses involving both cash and credit transactions.	Businesses involving predominantly cash transactions.
Reliability	As this method involves preparation of all accounts, it is comparatively much more reliable as it helps us ascertain correct profit.	This method involves preparation of only cash account and personal accounts, thus it is not a reliable basis for preparation of accounts. It does not lead us to correct profit.

Users	A profit oriented business enterprise usually prepares its accounts on accrual basis.	Professionals like Doctors, Lawyers etc, small ventures of temporary nature, some non-trading enterprises or institutions with service motive usually follow this method.
Adjustments	This method involves adjustment of accounts for preparation of financial statements.	It is a simple method as it does not involve many adjustments.