

FINANCIAL ACCOUNTING

UNIT-1

PART-III

BASIS OF ACCOUNTING SYSTEM

- Cash or receipt basis is the method of recording transactions under which revenues and costs and assets and liabilities are reflected in accounts in the period in which actual receipts or actual payments are made. “Receipts and payments account” in case of clubs, societies, hospitals etc., is the example of cash basis of accounting.
- Accrual or mercantile basis is the method of recording transactions by which revenues, costs, assets and liabilities are reflected in accounts in the period in which they accrue. This basis includes considerations relating to outstanding; prepaid, accrued due and received in advance. Revenue is accounted for when it is earned. Typically, revenue is recorded before any money changes hands. Unlike the cash method, the accrual method records revenue when a product or service is delivered to a customer with the expectation that money will be paid in the future. Expenses of goods and services are recorded despite no cash being paid out yet for those expenses.
- Hybrid or mixed basis is the combination of both the basis i.e. cash as well as mercantile basis. Income is recorded on cash basis but expenses are recorded on mercantile basis.

Key Differences

The key advantage of the cash method is its simplicity—it only accounts for cash paid or received. Tracking the cash flow of a company is also easier with the cash method.

But a disadvantage of the cash method is that it might overstate the health of a company that is cash-rich but has large sums of accounts payables that far exceed the cash on the books and the company's current revenue stream. An investor might conclude the company is making a profit when, in reality, the company is losing money.

Meanwhile, the advantage of the accrual method is that it includes accounts receivables and payables and, as a result, is a more accurate picture of the profitability of a

company, particularly in the long term. The reason for this is that the accrual method records all revenues when they are earned and all expenses when they are incurred.

For example, a company might have sales in the current quarter that wouldn't be recorded under the cash method because revenue isn't expected until the following quarter. An investor might conclude the company is unprofitable when, in reality, the company is doing well.

The disadvantage of the accrual method is that it doesn't track cash flow and, as a result, might not account for a company with a major cash shortage in the short term, despite looking profitable in the long term. Another disadvantage of the accrual method is that it can be more complicated to implement since it's necessary to account for items like unearned revenue and prepaid expenses.

Special Considerations

The accrual method is most commonly used by companies, particularly publicly-traded companies. One reason for the accrual method's popularity is that it smooths out earnings over time since it accounts for all revenues and expenses as they're generated instead of being recorded intermittently under the cash-basis method. For example, under the cash method, retailers would look extremely profitable in Q4 as consumers buy for the holiday season but would look unprofitable in Q1 as consumer spending declines following the holiday rush.

Both methods have their advantages and disadvantages, and each only shows part of the financial health of a company. Understanding both the accrual method and a company's cash flow with the cash method is important when making an investment decision.

Accrual Accounting vs. Cash Basis Accounting Example

Let's say you own a business that sells machinery. If you sell \$5,000 worth of machinery, under the cash method, that amount is not recorded in the books until the customer hands you the money or you receive the check. Under the accrual method, the \$5,000 is recorded as revenue immediately when the sale is made, even if you receive the money a few days or weeks later.

The same principle applies to expenses. If you receive an electric bill for \$1,700, under the cash method, the amount is not added to the books until you pay the bill. However, under the accrual method, the \$1,700 is recorded as an expense the day you receive the bill.

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