Cash basis accounting vs accrual basis accounting essay sample

There are two methods of accounting a business may use to record their transactions; cash basis accounting and accrual basis accounting. While both are effective, most businesses choose accrual basis accounting because cash basis accounting is not an acceptable form of accounting under Generally Accepted Accounting Principles (GAAP). However a small business may still elect to use this method. (Nobles, Mattison, Matsumura. 134) Cash basis accounting only records cash transactions, which gives little insight to the true financial position of a business. Where as, accrual basis accounting reports events as they occur. Income is only reported when earned and expenses are only reported when incurred. Since cash is always recorded when it is received an accountant will have to make adjustments to the financial statements to account for its prepaid and accrued expenses. (Nobels, et al. 134) A prepaid adjustment is where expenses are paid in advance for future expenses.

Now, the business must record the transaction when the cash is paid, but it must record accurately the expense as it is incurred. For example, a business may choose to prepay its rent for three months. Suppose they pay $3000 in January for the next three months rent. The cash payment is recorded in January, but the accountant must make an adjustment each month for the rent expense as it is incurred. Therefore, each month the accountant must make an adjustment for $1000 to account for that months rent expense. Originally the accountant would record a debit to the prepaid cash account and a credit to cash in the amount of $3000.

When making the adjustment the accountant would then record a debit to the rent expense account and a credit to the prepaid rent account in the amount of $1000, each month for the next three months. (Nobels, et al. 139) Another example of a prepaid transaction is recording the depreciation of plant assets. A plant asset is any asset the business has that may depreciate in value as time goes by, such as equipment, furniture or automobiles. If for example, a business purchases a vehicle for $60, 000, it must accurately report the depreciation of the vehicle where as not to inadvertently report an overage in its assets. To account for the depreciation the accountant would record the decline in its value over the lifetime of its usefulness. Let's assumes the business plans to keep the vehicle for 5 years before they replace it. The value of the vehicle will be divided over the 5 years becoming a monthly expense of $1000. The original record of the vehicle would have been recorded as a debit to the business' asset account and a credit to the owner's capital. To record the depreciation an adjustment is made by debiting the depreciation expense account and crediting the accumulating depreciation account each month for $1000 over the next 60 months. (Nobels, et al. 142)

The other type of adjustment that must be recorded is for accrued expenses. It would be nearly impossible for a business to record an expense every time it occurs, therefore an accountant will wait for an end of a period to account for its accrued expenses and make an appropriate adjustment. An example of an accrued expense would be the employee's salary. Suppose a business pays its employees on December 15th and again on January 1st. The business would report the first payday as a debit to the salaries expense account and a credit to cash. The adjustment entry would be for the second payday, since the expense was incurred in December but not paid until

January. The adjustment entry would be recorded as a debit to the salaries expense account and a credit to the salaries payable account. (Nobels, et al. 146) Another example of an accrued adjustment would be for accrued revenue. Accrued revenue is when a business earns revenue but has not yet been paid for it. For example a business may sign a contract to perform services for one month and earn $2000.

Assuming the agreement was made on January 15th and upon completion of the services the business will be paid on February 15th the business must make an adjustment for this transaction. The first entry will be made at the end of January for half of the earnings that were accrued in the month of January. The entry would record a debit to accounts receivable and a debit to service revenue. Then on February 15th when the business actually receives the cash an additional adjustment will be made which would be a debit to cash for the total amount earned; $2000. The accrual will be spilt into two entries; a credit of $1000 to service revenue and $1000 to accounts receivable. (Nobels, et al. 150) Neglecting to make the appropriate adjustments would result in either an overstatement or understatement of assets, liabilities, or equity. The ramifications would result in inaccurately representing the business' financial position. A lender may be inclined to lend to the business under false pretenses or may deny the business for a loan when they may otherwise qualify.

Cited Sources

Nobles, Tracie, Mattison, Brenda and Matsumura, Ella Mae. Horngren's Accounting. Upper Saddle River: Pearson, 2014. Print.