Accrual accounting

Finance

Cash flow statement is prepared separately to account for all the cash transactions and determine the hard cash position of the business apart from its profitability and sales figures, etc. If accounting was only based on cash, no credit transactions could have been made; in fact, we would have been violating the principle of “ Going Concern”. When we say businesses are a going concern, we usually pass entries to close accounts for an accounting period by transferring the balances to the next accounting cycle. This is done because business transaction keeps on taking place as business activities and operations are executed.

The key accounting concept for using the accruals versus cash is that the profits & losses are not actually documented by a business at the same time when the cash transaction is made. In fact, the two transactions are totally separate from each other and have different accounting treatments. Profits and losses of any business are the outcomes of its operations and revenue-generating activities which circulate around the ‘ income’ and ‘ expense’ heads of accounting for that business. This involves an expectation of cash inflows and outflows at a later date as well as deferred cash transaction or prepayments, etc. that needs settlement in a later period. Income and expense determine the cash that you might have earned or lost at the end of the day when all the corresponding cash transaction have been made but they strictly do not mean that cash has changed hands. We record the income and expenses in the period they are incurred in order to comply with accounting standards (Weygandt, Kieso, & Kimmel, 2007).