Cash basis vs. accrual basis accounting

Business, Accounting

Cash basis accounting predicts a periodic measure of performance that is used to predict future cash flows. This is the difference between cash receipts and cash payments from transactions related to providing goods and services during a reporting period. “ Revenue is recognized when cash is received and expense is recognized when cash is paid”. (" Accrual basis accounting,"). “ When transactions are recorded on a cash basis, they affect a company's books only once a completed exchange of value has occurred; therefore, cash basis accounting is less accurate than accrual accounting in the short term”. (Investopedia, 2013).

Accrual accounting doesn’t just focus on cash flows, instead, it also reflects other resources that are provided and consumed by business operations during a period. This method measures resources provided by business operations by revenue. The measure of resources used to earn revenues is expenses. The difference between revenues and expenses is net income/loss. Accrual basis net income provides a better measure of performance because it attempts to measure the resource inflows and outflows generated by operations during the reporting period, which may not provide the same amount of cash inflows and outflows.

Accruals involve transactions where the cash outflow or inflow takes place in a period after the expense or revenue recognition. “ Selling on credit and projects that provide revenue streams over a long period of time affect the company's financial condition at the point of the transaction. Therefore, it makes sense that such events should also be reflected on the financial statements during the same reporting period that these transactions occur”.

(Investopedia, 2013). While cash basis is the difference between cash receipts and cash disbursements from providing goods and services.

For cash basis accounting, a transaction happens only whenmoneyis exchanged. “ Revenues are reported on the income statement when cash is received from the customers. Expenses are reported on the income statement when cash is paid out. This is one of the problems with cash basis accounting because adjusting entries help ensure that all revenues earned in a period are recognized in that same period, regardless of when cash is received”. (Averkamp, 2004). For accrual basis accounting, “ revenues are recorded on the income statement when they are earned, which more often than not occurs before cash is received.

Expenses are recorded on the income statement in the period when they occur/expire which is often in a different period from when the payment is made. This method of accounting provides a better picture of the company’s profits during an accounting period because the income statement will report all of the revenues actually earned during the period and all of the expenses incurred in order to earn the revenues. This method also helps because it reports all the assets that were earned are reported and all the liabilities that were incurred are reported”. (Averkamp, 2004).