

Free essay on description and comparison of accrual and cash basis of accounting

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Introduction: Accrual and Cash basis of accounting are the two methods of making a record of the business transactions in the organization's records. According to Rich, Jones, Mowen & Hansen (2012) " Under Cash basis accounting, revenues and expenses are recorded when cash is received or paid regardless of when the revenues are earned or the expenses are incurred. Accrual basis accounting; links income measurement, to the selling activities of a company by recognizing revenues and expenses when they occur" (p. 135).

The accrual basis of accounting adheres to the revenue recognition and expense recognition principle as laid down by the Generally Accepted Accounting Principles whereas the cash basis of accounting contradicts with these two principles. Hence, the accrual basis of accounting is always preferred by the Generally Accepted Accounting Principles.

Differences between the Accrual and Cash basis of accounting: Under the cash based accounting, a company's financial statements do not reflect the exact position of its assets and liabilities on a given date because of which the cash based accounting is not very popular among companies. Accrual based accounting records the transaction on the event of their occurrence irrespective of the realization of the cash and since makes a record of both cash and non-cash transactions, is very complicated when compared to the cash basis of accounting (Rich et al., 2012, p. 111). Under accrual based accounting, the concept of Adjusting entries is brought into use so as to ensure the adherence to the principles of revenue recognition and expense recognition (Kimmel, Weygandt & Kieso, 2011, p. 167). While cash based accounting is clear-cut, accrual based accounting is known to be complex.

Because of the limited choices available cash based accounting is simpler when compared to the accrual based accounting which makes every possible attempt to reflect both cash and non cash transactions. Hence the accrual based balance sheet reflects a more accurate financial position of the organization's current condition as opposed to the cash based balance sheet. Also, as per the suggestion from the European Union, many public sector companies across the world adopt accrual base accounting (Adriana, Alexandra, Tudor & Mutiu, 1990). A study by Cohen and Zarowin (2008) noted that “ firms that engage in both real and accrual earnings management activities have greater investment effects than firms that engage in one or the other alone” (p. 26).

Conclusion: Due to its efficacy in presenting a more accurate financial position of a firm and its adherence to the accounting principles laid down by GAAP, the accrual based accounting is persistently being adopted by numerous organizations and also preferred by the Commercial accounting and generally accepted accounting principles. Also, an organization's future cash flow forecasts are based on the presentation of correct financial position which is possible only by employing principles of income recognition and matching principle as provided by accrual based accounting, so as to aid in the business and economic decision making.

1. Rich, J., Jones, J., Mowen, M., & Hansen, D. (2012). Cornerstones of Financial Accounting. Oklahoma: Cengage Learning.
2. Kimmel, P. D., Weygandt, J. J., Kieso, D. E. (2011). Financial Accounting: Tools for Business Decision Making. New Jersey: John Wiley & Sons, Inc.
3. Cohen, D. & Zarowin, P. (2008). Economic Consequences of Real and

Accrual-Based Earnings Management Activities. Retrieved from <https://jindal.utdallas.edu/files/Zarowin.pdf>.

4. Tudor, T. Adriana, Mutiu & Alexandra. (1990). Cash Versus Accrual Accounting in Public Sector. Study at University Babes Bolyai. Available at SSRN: <http://ssrn.com/abstract=906813>.