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Cash/Accrual Basis Paper

Cash Basis and the Accrual Basis

In the field of accounting, there are two ways of recording business financial accounting transactions: the cash method and the accrual method. The article "Using the Basic Accounting Equation to Help Students Understand Differences between the Cash Basis and Accrual Basis," by Neal VanZante describes the differences between the cash and accrual methods. In the article, Neal uses example cases to illustrate how these two methods are different from each other. The two examples that he gives cover two types of businesses, a service type company and a retail company that have to manage inventory.

First we need to understand the differences between the cash basis and accrual basis of recording transactions. "Under the accrual basis, companies record transactions that change a company's financial statements in the period in which the events occur" (Weygandt, Kimmel, Kieso 101). For example, if I purchase a laptop for my company on account, I would document the purchase the moment that I purchased the laptop. "Under the cash-basis accounting, companies record revenue when they receive cash" (Weygandt, Kimmel, Kieso 101). Instead of documenting the transaction the moment I purchased the laptop, I would document the purchase when I pay for it.

Next we go to the service organization and retail company examples. The first case that Neal describes is in regard to a service organization. With a service organization, the company does not have any fixed assets or inventories that have to be accounted for. If the company uses the cash basis, the recording of transactions (both revenue and expenses) are only documented

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However, this can be very harmful towards the company. If when the owner or manager look at the accounting books and see that they have excess money to spend, they might accidentally disregard a future bill that hasn't arrived yet. Since they do not document anything until there is the exchanging of cash, they might be unaware of the future cost that they will have to deal with. The excess money that they had was in reality there to support the payment of future bills that were going to be coming in (Alexander).

Just like the cash basis, using the accrual basis also has its pros and cons. With the accrual process, when a transaction is made, either in regard to revenue or some sort of expense, that transaction is recorded. This allows for a more accurate reading of the company's finances. They know what revenues they expect to be getting paid for along with any potential expenses that will arise. However, when using the accrual basis, the revenue portion of the accounting equation might be of some concern. For example, a company might have an outstanding accounts receivable that is to be due by some customer. However, that customer might not pay that bill or may not pay in a timely manner. This would lead to the false statement that the company is going to get paid for that revenue, which it might not (Harris).

There is also the difference between the two accounting practices when preparing tax returns. When using the cash basis method, the business only reports the revenues and expenses when there is the actual exchanging of currency, not necessarily at the time that it is earned. "An advantage of the cash method is that taxpayers can pay their expenses at year end or wait until the beginning of the next year to better manage their tax deductions" (Natenstedt). This allows for more flexibility for the company; however the Internal Revenue Service (IRS) is not too fond of this method. These companies can alter their tax returns to yield the highest payout. With the accrual basis on the other hand, the tax preparations accurately reflect the businesses

financial transactions. Since all of the transactions are recorded when earned or expended, it accurately reflects their cash inflow/outflow which allows the IRS to tax them accordingly (Natenstedt).

After researching both the cash basis and the accrual basis, I believe that companies should convert their accounting practices towards the accrual method. There are several reasons as to why this method should be used rather than the cash basis. For one, it leads people to accurately see their net income or even their net loss. By seeing every financial transaction that has occurred, whether it is in revenues or expenses, it could reflect what the company's net finances are at any time. Under the accrual method, there would be no instances (such as in the cash basis) where a company thought that they yielded a large profit, where in reality, they might have some sort of expense that they haven't accounted for yet. With the accrual basis, the company finances of the future payments of expenses are all documented from the date of order. This will allow a decision maker in the company to view all of the expense(s) and decide if it is wise to be purchasing any additional goods.

Another reason as to why I believe that the accrual basis should be used is an ethical one, is to keep everyone honest in the finances of the company. In the cash method, the finances of the company can be altered to inaccurately present the finances of the company. One possible scenario as to why a company might do this is to "meet a previously announced goal and thus meet the expectations of the market" (Needles, Powers 103). Taking the preceding example, if a company is using the cash basis method, they can alter the revenues and expenses to meet any expectation that they had. If word got out that the company was unethical and hiding negative financial information, they could lose the trust of all of their investors and might end up going out of business. By using the accrual method, the company records all transactions that both

involve revenue(s) and expense(s). This will allow the IRS and any investors to see the true finances of the company. The true finances of a company might be either good or bad, but in the end it is better to be ethical and honest in representing your company than to be a liar.

Works Cited

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