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NEWSLETTER

DEMYSTIFYING ACCRUAL ACCOUNTING

When interacting with your accounting colleagues, I am sure you have come across terms such as "month-end accruals" or the need to "accrue" for some expenses.

To properly understand the basis of how your typical company financial statements are prepared, it is necessary to appreciate the concept of accrual.

So what is accrual?

Cash basis

It might be easier to understand accrual by first knowing what is called the cash basis of accounting.

The cash basis of accounting, as its name suggests, records only cash transactions. This makes it the simplest form of accounting. For example, if you receive cash, it is treated as revenue. When you pay out cash, it is considered as an expense.

While it is simple, its drawbacks are that it does not depict economic transactions comprehensively enough.

So for example, if you perform services for a customer and have not been paid, this transaction will not be recorded under the cash basis of accounting.

Only when cash is received will the revenue be recorded.

What are the consequences of this?

Cash basis accounting records only cash transactions

Inadequacies of cash basis

Without recording the services performed as revenue in the Income Statement, the cash basis omits the recording of an important economic activity of the company.

It also means that the Balance Sheet does not capture the existence of an account receivable from the customer. The cash basis would have omitted the existence of an important asset -- a claim to receive cash from your customer in the future.

ACCRUAL ACCOUNTING

Recording is triggered by the occurrence of a business activity

Accrual basis

The accrual basis, on the other hand, is designed to record a business activity or transaction as it occurs.

Using the same example, if you perform services for your customer, accrual accounting would record the activity as revenue in the Income Statement and recognises the existence of an account receivable in the Balance Sheet immediately.

On receipt of payment from your customer subsequently, accrual accounting will record the activity involving the collection of cash and the reduction in the account receivable.

As you can see, cash transactions are recorded fully under accrual accounting.

In addition, accrual accounting also records transactions even though there is no immediate exchange of cash, which will be excluded if the cash basis is used.

Cash and non-cash transactions

To further illustrate, some examples of cash transactions that will be recorded under accrual accounting include:

- Cash receipts from customers
- Payments to suppliers
- Bank borrowings or repayments
- Selling shares to raise equity

Examples of non-cash transactions recorded under accrual accounting include:

- Credit sales to customers
- Credit purchases from suppliers
- Unpaid expenses incurred
- Depreciation expenses
- Provision for doubtful debts

Accrual accounting records cash and non-cash transactions

Not perfect

The last three items on the list of non-cash transactions require considerable judgment, as you can imagine. As a result, while accrual accounting is comprehensive, it is also susceptible to manipulation as the transactions that passed through the system need not all be supported or verified by cash. Consequently, cases of overstatement of revenue and account receivables are not uncommon. As such, it leads to the saying:

Profit is an opinion.

Cash is a fact.

About the author

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