GLOBAL INITIATIVE

How-to-Guide
Accrual Accounting vs. Cash Basis Accounting
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Background

With the end/ beginning of a fiscal year comes many questions on invoicing. This has an impact on project code used, date on the invoice, description of the work done.

This guide has been prepared to provide a summary of a major accounting principle that Global Initiative follows. **We are using an accrual accounting principal across the organisation.** This is commonly accepted by all donors. Most of the document, if not all, has been a copy and paste exercise from the following website https://www.investopedia.com/ask/answers/09/accrual-accounting.asp

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Accrual Accounting vs. Cash Basis Accounting: An Overview

The main difference between accrual and cash basis accounting lies in the timing of when revenue and expenses are recognized. The cash method provides an immediate recognition of revenue and expenses, while the accrual method focuses on anticipated revenue and expenses.

Key Takeways

- Accrual accounting records revenue and expenses when transactions occur but before money is received or dispensed.
- Cash basis accounting records revenue and expenses when cash related to those transactions actually is received or dispensed.
- Accrual accounting provides a more accurate view of a company's health by including accounts payable and accounts receivable.
- The accrual method is the more commonly used method by large companies, especially by publicly-traded companies, as it smooths out earnings over time.
- The cash basis method typically is used by sole proprietors and smaller businesses.

Accrual Accounting

Under this method, revenue is accounted for when it is earned. Unlike the cash method, the accrual method records revenue when a product or service is delivered to a donor with the expectation that money will be paid in the future. In other words, money is accounted for before it's received. Likewise, expenses for goods and services are recorded before any cash is paid out for them.

Cash Basis Accounting

Under this method, revenue is reported on the income statement only when cash is received. Expenses are recorded only when cash is paid out. The cash method is typically used by small businesses and for personal finances.

Key Differences

Accrual Method

The accrual method records invoices received and ones issued to a donor, as a result, can provide a more accurate picture of the financial situation of a company, particularly in the long term.
For example, an organisation might have incomes in the current quarter that wouldn't be recorded under the cash method. An external viewer might think the organisation is making a deficit when, in reality, the organisation is doing well.
The accrual method doesn't track cash flow. An organisation might look profitable in the long term but actually have a challenging, cash shortage in the short term.
Another disadvantage of the accrual method is that it can be more complicated to use since it's necessary to account for items like expenses paid in advance.
The accrual method typically is required for organisations that file audited financial statements and is accepted under the generally accepted accounting principles (GAAP).

Cash Basis Method

The key advantage of the cash method is its simplicity—it only accounts for cash paid or received. Tracking the cash flow of a company is also easier.
It's beneficial to sole proprietorships and small organisation because, most likely, it won't require added staff (and the related expenses) to use.
However, the cash basis method might overstate the health of an organisation that is cash-rich. That's because it doesn't record invoices to be paid that might exceed the cash on the books and the organisation's current income stream.
As a result, an external viewer might conclude the organisation is making a profit when, in reality, it might be facing financial difficulties.
The cash basis method is not acceptable under GAAP.

Special Considerations

The Global Initiative is using the accrual method. It is the more commonly used method, particularly by publicly-traded companies. One reason for the accrual method's popularity is that it smooths out earnings over time since it accounts for all revenues and expenses as they're generated. The cash basis method records these only when cash changes hands and can present more frequently changing views of financial situation or profitability.

For example, under the cash basis method, retailers would look extremely profitable in Q4 as consumers buy for the holiday season. However, they'd look unprofitable in the next year's Q1 as consumer spending declines following the holiday rush.

Both methods have their advantages and disadvantages. Each provides different views of the financial health of a company. For external viewers, it's important to understand the impact of both methods when making investment decisions.

Accrual Accounting vs. Cash Basis Accounting Example

Let's say you own a business that sells machinery. If you sell $5,000 worth of machinery, under the cash method, that amount is not recorded in the books until the customer hands you the money or you receive the check.

Under the accrual method, the $5,000 is recorded as revenue as of the day the sale was made, though you may receive the money a few days, weeks, or even months later.

The same principle applies to expenses. If the company receives an electric bill for $1,700, under the cash method, the amount is not recorded until the company actually pays the bill. However, under the accrual method, the $1,700 is recorded as an expense the day the company receives the bill.