

# Bases of Accounting

## LEARNING OBJECTIVES

*This Chapter would enable you to understand:*

- Bases of Accounting:
  - Cash Basis
  - Accrual Basis
- Difference between Accrual Basis of Accounting and Cash Basis of Accounting

The most significant function of accounting is to determine profit earned or loss incurred by a business during an accounting period.

Profit earned or loss incurred by the business can be determined either by 1. Cash Basis of Accounting or 2. Accrual or Mercantile Basis of Accounting.

### 1. Cash Basis of Accounting

Cash basis of accounting is a system in which transactions are recorded when cash is transacted, whether received or paid. It means, revenue is recognised on receipt of cash. Likewise, expenses are recorded as incurred when they have been paid. The difference between the total incomes and total expenses represents Profit or Loss of a business for the accounting period. Thus, when Cash Basis of Accounting is followed, outstanding and prepaid expenses and income received in advance or accrued incomes are not considered. Receipts and Payments Account prepared in case of Not-for-Profit Organisations, such as charitable institutions, clubs and schools, is an example of accounting on cash basis.

**Outstanding Expenses** are those expenses which have become due during the accounting period but which have not yet been paid.

**Prepaid Expenses** are those expenses which have been paid in advance.

**Accrued Income** is an income which has been earned during the accounting period but has not yet become due and, therefore, has not been received.

**Income Received in Advance** is an income which has been received before it has been earned, i.e., goods to be sold or services to be rendered in future.

**Advantages:** Advantages of Cash Basis of Accounting are:

- (i) It is a simple basis of accounting as adjustments for outstanding expenses, prepaid expenses, accrued income and income received in advance is not made.
- (ii) This approach is more objective as very few estimates and judgments are required.
- (iii) This basis of accounting is suitable for those enterprises where most of the transactions are on cash basis.

**Disadvantages:** Disadvantages of Cash Basis of Accounting are:

- It does not give a true and fair view of the profit or loss and the financial position of an enterprise because it ignores outstanding and prepaid expenses and accrued income and income received in advance.
- It does not follow the Matching Principle of accounting.
- This system does not distinguish between capital and revenue items and, as a result, there is no consistency in the profits of the two years.

#### Illustration 1.

During the financial year 2018–19, Ashok had cash sales of ₹ 3,90,000 and credit sales of ₹ 1,60,000. His expenses for the year were ₹ 2,70,000, out of which ₹ 80,000 is still to be paid. Find out Ashok's income for 2018–19 following the Cash Basis of Accounting.

**Solution:**

Revenues (inflow of cash, i.e., cash sales)	3,90,000
Less: Expenses (outflow of cash) (₹ 2,70,000 – ₹ 80,000)	1,90,000
<b>Net Income</b>	2,00,000

**Note:** Credit sales and outstanding expenses will not be considered under Cash Basis of Accounting.

#### 2. Accrual Basis of Accounting

Under Accrual Basis of Accounting, unlike under Cash Basis of Accounting, income is recorded as income when it is earned or accrued. For example, credit sale is recognised as sale irrespective of the fact whether amount has been received or not. Similarly, if an expense has been incurred but payment has not been made, it will be recorded as an expense. For example, rent for the month of March, 2019 has not been paid. It will still be recorded as an expense because it had become due.

Accrual Basis of Accounting is based on the concept of realisation and expiration and follows two basic accounting principles, i.e., Revenue Recognition Principle and Matching Principle. Thus, under the Accrual Basis of Accounting, outstanding and prepaid expenses are adjusted. Similarly, accrued income and income received in advance are recognised for ascertaining correct profit or loss for the accounting period.

It may be noted that the Companies Act, 2013 requires companies to follow accrual basis of accounting in maintaining the books of account.

**Advantages:** The advantages of Accrual Basis of Accounting are:

- It is more scientific compared to Cash Basis of Accounting and hence is preferred by accountants.
- This basis of accounting shows a complete picture of financial transactions of the business as it takes into account the effect of all transactions relating to a period as well as adjustments like outstanding expenses, prepaid expenses, accrued income and income received in advance.
- This basis discloses correct profit or loss for a particular period and also exhibits true financial position of the business on a particular day.
- It reflects true profit or loss during the accounting period and, therefore, has wide acceptability.
- It reflects true financial position at the end of the accounting period by adjusting outstanding expenses, prepaid expenses, accrued income and income received in advance, etc.

**Disadvantages:** The disadvantages of Accrual Basis of Accounting are:

- This system is not as simple as Cash Basis of Accounting.
- The accounting process is too elaborate.
- A quick appraisal of the profit/loss is not possible because many adjustments are required to ascertain the true financial position of the business.

#### Illustration 2.

Taking the figures in Illustration 1, find out the net income according to Accrual Basis of Accounting.

**Solution:**

Total Sales = Cash Sales (₹ 3,90,000) + Credit Sales (₹ 1,60,000)	5,50,000
Less: Total Expenses for the Year	2,70,000
<b>Net Income</b>	2,80,000

**Note:** ₹ 80,000 expenses still to be paid belong to this year and hence are to be charged to the revenue of this year. Similarly, credit sales of ₹ 1,60,000 are taken in the year in which sales transaction is done.

#### Difference between Accrual Basis of Accounting and Cash Basis of Accounting

Basis	Accrual Basis of Accounting	Cash Basis of Accounting
1. Nature of Transactions	Both cash and credit transactions are recorded.	Cash transactions are recorded.
2. Prepaid/Outstanding Expenses	Prepaid and outstanding expenses are accounted in the Profit and Loss Account.	Prepaid and outstanding expenses are not adjusted. Similarly, accrued income and income received in advance are not adjusted.
3. Profit or Loss	Accrued income and income received in advance are also accounted and shown in the Balance Sheet.	Correct profit or loss is not ascertained because both cash and credit transactions.
4. Technical Knowledge	Correct profit or loss is ascertained because it records both cash and credit transactions.	It records only cash transactions.
5. Legal Position	The Accrual Basis of Accounting requires technical knowledge as many adjustments like prepaid, outstanding, capital and revenue are required to be made.	It does not require much of technical knowledge as is required for Accrual Basis of Accounting.
6. Acceptability	Accrual Basis of Accounting is recognised by the Companies Act, 2013.	It does not require much of technical knowledge as is required for Accrual Basis of Accounting.
7. Reliability	Accrual Basis of Accounting is more acceptable in business as it reveals correct income and expense besides assets and liabilities.	Cash Basis of Accounting is not acceptable in business as it does not reveal the required information.
8. Suitability	Accrual Basis of Accounting is more reliable as it records both cash and credit transactions and thus, reveals correct profit or loss besides assets and liabilities.	Cash Basis of Accounting is less reliable as it records only cash transactions and as a result does not reveal correct profit or loss and also assets and liabilities.
	Accrual Basis of Accounting is suitable for businesses as it requires information that is complex. It can be made available by Accrual Basis of Accounting.	Cash Basis of Accounting is suitable for Not-for-Profit Organisations and Professionals such as chartered accountants, lawyers, etc., since they require comparatively less information.

### QUESTIONS

#### Higher Order Thinking Skills (HOTS) Questions

**Q. 1.** Dr. Arvind Kishore, a homeopath doctor in practice has been advised by his Accountant to maintain his accounts on Accrual Basis instead of the presently followed Cash Basis of Accounting. Do you agree with the advice of the Accountant? Give reasons.

**Ans.** No, I do not agree. Cash Basis of Accounting is more appropriate for Dr. Arvind Kishore because a medical practitioner receives his fee immediately after giving consultancy.

**Q. 2.** M/s Kalra Bros., a dealer in computer hardware, has received an order for 10 computers along with an advance of ₹ 50,000. The firm maintains its accounts on Accrual Basis of Accounting. Should the amount received, i.e., ₹ 50,000 be credited to the Sales Account or to the Advance Received Account? Give reasons for your answer.

**Ans.** It should be credited to the Advance Received Account and later transferred to the account of purchaser on affecting sale.

#### Multiple Choice Questions (MCQs)

Select the correct alternative:

(i) Under the Cash Basis of Accounting, expenses are recorded

(a) on payment.

(c) either (a) or (b).

(ii) Under the Accrual Basis of Accounting, expenses are recorded

(a) on payment.

(c) either (a) or (b).

(iii) Accrual Basis of Accounting

(a) does not give a true and fair view of profit and financial position.

(b) gives a true and fair view of profit and financial position.

(c) may or may not give a true and fair view of profit and financial position.

(d) None of the above.

(iv) Accrual Basis of Accounting recognises

(a) Outstanding and Prepaid Expenses.

(b) Accrued Incomes and Incomes Received in Advance.

(c) Both (a) and (b).

(d) None of the above.

(v) Under Accrual Basis of Accounting

(a) both Cash and Credit transactions are recorded.

(b) only cash transactions are recorded.

(c) only credit transactions are recorded.

(d) None of the above.

[ (i) (a); (ii) (b); (iii) (b); (iv) (c); (v) (a). ]

### Bases of Accounting

#### Very Short Answer Type Questions

(KVYS 2010)

**Q. 1.** What are the two bases of accounting?

**Ans.** There are two bases of accounting:

(i) Cash Basis and (ii) Accrual Basis.

**Q. 2.** What do you understand by Cash Basis of Accounting?

**Ans.** Cash Basis of Accounting means that the entry is recorded on receipt or payment of cash. The system does not distinguish between capital and revenue items. It also does not recognise prepaid expenses and outstanding expenses.

(Delhi 2010)

**Q. 3.** What do you understand by Accrual Basis of Accounting?

**Ans.** Accrual Basis of Accounting means the transaction is recorded at the time when it is entered into and not when the settlement takes place. In other words, under Accrual Basis of Accounting, accounting entries are recorded when incomes are earned and expenses are incurred irrespective of cash received or paid.

**Q. 4.** Distinguish between Cash Basis and Accrual Basis of Accounting. (Two Points)

**Ans.** (i) Both cash and credit transactions are recorded under the Accrual System of Accounting. Under the Cash System of Accounting only cash transactions are recorded.

(ii) Capital and revenue items are distinguished under the Accrual System of Accounting. Under the Cash System of Accounting no such distinction is made.

**Q. 5.** What are the advantages of Cash Basis of Accounting? (Two Points)

**Ans.** Advantages of Cash Basis of Accounting are:

(i) It is a simple system as adjustments are not required.

(ii) It is more objective as very few estimates and judgments are made.

**Q. 6.** What are the disadvantages of Cash Basis of Accounting? (Two Points)

**Ans.** Disadvantages of Cash Basis of Accounting are:

(i) It does not give a true and fair view of profit or loss and the financial position.

(ii) It does not follow the Matching Principle.

**Q. 7.** Does cash basis of accounting violates GAAP? If Yes, how?

**Ans.** Yes, cash basis of accounting violates GAAP as it does not follow matching principle and accrual concept.

**Q. 8.** What are the advantages of Accrual Basis of Accounting? (Two Points)

**Ans.** Advantages of Accrual Basis of Accounting are:

(i) It gives a true and fair view of profit or loss and the financial position.

(ii) It shows complete picture of financial transactions as it accounts prepaid and outstanding expenses, earned and unearned incomes, assets and liabilities.

**Q. 9.** What are the disadvantages of Accrual Basis of Accounting? (Two Points)

**Ans.** Disadvantages of Accrual Basis of Accounting are:

(i) The accounting process is more elaborate.

(ii) It is more complicated than Cash Basis of Accounting and requires adequate skills.

**Short Answer Type Questions**

1. Discuss Cash and Accrual Basis of Accounting.
2. Write down any three differences between Cash Basis and Accrual Basis of Accounting.  
(Delhi 2007; MSE Chandigarh 2008, KVS 2012, 2013)
3. What is meant by Accrual Basis of Accounting? Give two advantages of Accrual Basis of Accounting.
4. What is meant by Cash Basis of Accounting? Give two disadvantages of Cash Basis of Accounting.
5. During the financial year 2018–19, Mohan had cash sales of ₹ 90,000 and credit sales of ₹ 60,000. His expenses for the year were ₹ 70,000 out of which ₹ 30,000 is still to be paid. Find out Mohan's income for 2018–19 following the Cash Basis of Accounting.  
[₹ 50,000.]
6. Taking the figures given in Q. 5, find out the net income according to Accrual Basis of Accounting.  
[₹ 80,000.]
7. Vijay, a consultant, during the financial year 2018–19 earned ₹ 4,00,000. Out of which he received ₹ 3,50,000. He incurred an expense of ₹ 1,70,000, out of which ₹ 40,000 are outstanding. He also received consultancy fee relating to previous year ₹ 45,000 and also paid ₹ 20,000 expenses of last year.  
You are required to determine his income for the year if
  - (i) he follows Cash Basis of Accounting and  
[₹ 2,45,000; (ii) ₹ 2,30,000.]
  - (ii) he follows Accrual Basis of Accounting.



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