LEARNING OBJECTIVES

1. **Explain** how accrual accounting differs from cash-basis accounting
2. **Apply** the revenue and expense recognition principles
3. **Adjust** the accounts
4. **Prepare** updated financial statements
5. **Close** the books

EXPLAIN HOW ACCRUAL ACCOUNTING DIFFERS FROM CASH-BASIS ACCOUNTING

1 **Explain** how accrual accounting differs from cash-basis accounting

Shareholders want to earn a profit. Investors search for companies whose share prices will increase. Banks seek borrowers who will pay their debts. Accounting provides the information these people or institutions use for decision making. Accounting can be based on one of the following:

- Accrual basis
- Cash basis

Accrual accounting records the impact of business transactions and events on an entity's assets and liabilities over the period in which they occur, even if the resulting cash receipts or payments occur in a past or future period. For example, when a business performs a service, makes a sale, or incurs an expense, the accountant records the transaction even if it receives or pays no cash at the time of the transaction.

Cash-basis accounting records only cash transactions—cash receipts and cash payments. Cash receipts are treated as revenues, and cash payments are handled as expenses. Profits are earned when cash receipts are greater than cash payments, and similarly, losses are incurred when cash receipts are less than cash payments.

To illustrate the difference between the two bases of accounting, consider the following example. Richemont sells inventory produced at the cost of €500 to a customer for €800 on account. The customer promises to pay in 60 days' time. Accrual accounting would recognize the €800 as income because making the sale increases Richemont's wealth and Richemont now has the right to some future economic benefits (in the form of receivables, an asset). The eventual payment is merely an exchange of one asset (receivable) for another (cash) and has no impact on Richemont's income. Cash accounting, on the other hand, will not record a sale as there was no exchange of cash at the time of the sale. Only when cash is received (60 days later) will cash basis accounting record the transaction.

Cash accounting fails to capture the underlying economic phenomenon. First, the €800 receivable represents a claim to receive cash in the future, which is an asset, and it should appear on the Balance Sheet. Without it, assets are understated. Second, the increase in assets also results in an increase in equity and should be recognized as income. Without it, income is understated.

Suppose Richemont paid a portion of the office rent prior to the actual occupation. Cash may have been paid, but has Richemont actually incurred the expense? Obviously not. If you look at Richemont's Balance Sheet at the start of this chapter, you will see on line 6, prepayments totaling €135 million. These are monies paid to various parties that continue to represent future economic benefits to Richemont, and are thus accounted for as an asset. As the prepayments are consumed, Richemont will recognize a reduction of assets and an increase in expense. Cash accounting would have treated all payments as expenses, i.e., understating assets and overstating expenses.

On the other hand, Richemont may have consumed economic benefits without paying for them. It will "accrue" (more on this later) these obligations as liabilities. Richemont also collected money in advance of selling its merchandise.

The take-away lessons from this discussion are as follows:

- Virtually all businesses use the accrual basis of accounting as required by financial reporting standards.