Accrual Basis of Accounting

Accrual basis of accounting is a method of accounting that recognizes revenue and expenses when earned or incurred rather than when cash is received. The difference between accounting income and cash receipts are known as “accruals.” It is this difference between the net income and the net cash receipts that creates all the non-cash assets on the balance sheet.

The main alternative to an accrual basis of accounting is the cash basis of accounting. The cash basis of accounting is used mainly by service-type of industries (e.g. law firms and architectural firms) because of its simplicity and because of the tax benefits it provides.

Over the long run (theoretically), accrual basis of accounting and cash basis of accounting should lead to exactly the same numbers in the financial statements. In practice, this probably will not happen perfectly; but the point is that the only difference between the two accounting methods is supposed to be the timing with which they recognize certain transactions.

The accrual basis of accounting is a more accurate method of accounting for transactions; and consequently, it usually results in financial statements that are more meaningful and more useful for prediction.

However, accrual accounting can be abused by accountants who are more concerned about making “the numbers look good” than with giving an accurate description of how a company performed. It is up to the analyst and the investor to study the accruals, determine if they are reasonable, and adjust them if they are not.