



# International Cotton Advisory Committee

Attachment 7

## Best Accounting System for the ICAC: Cash Basis vs. Accrual Accounting Systems 564<sup>th</sup> Meeting of the Standing Committee

16 April 2020  
Virtual Meeting on GoToMeeting  
<https://global.gotomeeting.com/join/237405149>



---

**Attachment 7 to SC 564  
16 April 2020**

**For Decision**

**Cash Basis vs. Accrual Accounting Systems – the Advantages and Disadvantages**  
**Report presented to the Steering Committee of the 2019 Plenary meeting, Brisbane, Australia.**

**1. Introduction**

At the 561<sup>st</sup> meeting of the Standing Committee on the 19<sup>th</sup> September 2019, there was discussion as to whether the ICAC should switch from its current method of cash basis accounting to accrual accounting. The result of that discussion was that equally valid views were put forward in favour of both systems to such an extent that the Standing Committee are now looking to the Steering Committee for direction and advice.

The relevant comments made at that meeting and recorded in the minutes were as follows;

*“The Delegate from the EU encouraged all the delegates to consider switching to an accrual system for the next fiscal year to get a correct and clear picture of the organisation’s finances and to adhere to the international accounting standard.*

*The Delegate from USA explained that a Cash Basis system wasn’t really hampering the understanding of the ICAC account, since all delegates could work out the financial position from the amount of assessments that were due. He favoured a full discussion within the Standing Committee before deciding which way to go.*

*The Chair of the Subcommittee on Budget recommended bringing the matter before the Steering Committee to explain the issue and with the recommendation that the Standing Committee be given authority to make a decision after a full discussion on the topic.”*

The cash basis and accrual basis of accounting are two different methods used to record accounting transactions. The core underlying difference between the two methods is in the timing of when the transaction is recorded. When aggregated over time, the results of the two methods are approximately the same. In cash basis accounting, revenue is recorded when cash is received from customers and expenses are recorded when cash is paid to suppliers and employees. In accrual basis accounting, revenue is recorded when earned and expenses are recorded when consumed i.e. when they are billed (but not paid).



---

The timing difference between the two methods occurs because revenue recognition in the accounts is delayed under the cash basis method until the customer's payment is received by the ICAC. Similarly, the recording of expenses under the cash basis method can be delayed until a supplier's invoice is paid.

Below is an explanation of each system in more detail, highlighting the advantages and disadvantages to each approach.

## **2. Cash basis accounting**

The cash basis of accounting recognizes revenues when cash is received, and expenses when they are paid. It does not recognise accounts receivable or accounts payable.

Many small businesses for example, opt to use the cash basis of accounting because it is simple to maintain. It's easy to determine when a transaction has occurred (the money is in the bank or out of the bank) and there is no need to track receivables or payables.

The cash method is also beneficial in terms of tracking how much cash the organisation actually has at any given time; you can look at your bank balance and understand the exact resources at your disposal. In many ways it is no different to running your own checking/current account.

Also, since transactions aren't recorded until the cash is received or paid, in businesses which pay tax, the business's income isn't taxed until it's in the bank. This does not apply to the ICAC as we do not pay business taxes.

## **3. Advantages of cash accounting**

It is a simplified process. Many small business owners choose the cash basis method for accounting because it is a simplified bookkeeping process that is similar to how you would track your own personal finances. It is easy to track money as it moves in and out of the organisation's bank account because there is no need to record receivables or payables.

For small companies or organisations that conduct their business primarily through cash transactions and do not maintain large inventories of products, the cash basis accounting method can be a convenient and reliable way to keep tabs on revenue and expenses without the need for a great deal of bookkeeping.

In addition, for organisations that need to pay business taxes, cash basis accounting has distinct advantages. With this method, you don't have to pay taxes on any money that has not yet been received. This helps improve cash flow and helps ensure that small businesses have funds available for tax payments.



#### **4. Disadvantages of cash basis accounting**

As cash basis accounting doesn't account for all incoming revenue or outgoing expenses, this method can lead to an inaccurate financial picture.

Additionally, because the method is so simple it does not require the accountant or bookkeeper to keep track of the actual dates corresponding to specific sales or purchases. There are therefore, no records of Accounts Receivable or accounts payable which can create difficulties when the organisation does not receive immediate payment or has outstanding bills.

Cash basis accounting does not conform to Generally Accepted Accounting Principles or GAAP. GAAP are the standard framework of rules and guidelines that accountants in the United States must adhere to when preparing financial statements. Under these guidelines, all companies with sales over \$25 million must use the accrual method when bookkeeping and reporting their financial performance.

Whilst this limit does not apply to the ICAC, the organisation has entered into contracts for grant funding from organisations such as GIZ, where there is a requirement for the organisation to maintain international accounting standards. Cash basis accounting may not comply with international accounting standards.

#### **5. Accrual basis accounting**

Accrual accounting is a method of accounting where revenues and expenses are recorded when they are earned, regardless of when the money has actually been received or paid. For example, you would record revenue on the date when an invoice is generated, rather than on the date when you get paid. And conversely, you record expenses on the date they occur or the date of the bill rather than the date when you receive the bill.

Accrual basis accounting is more commonly used than the cash method.

Whilst cash basis accounting provides a clear short-term vision of the organisation's financial situation, accrual basis accounting provides a more long-term view of how the organisation is performing.

This is because accrual accounting accurately shows how much money you earned and spent within a specified time period and thus a more realistic idea of income and expenses during that period, therefore providing a long-term picture of the business that cash basis accounting can't provide. It also allows for the reporting of the organisation's true profitability at the end of the financial year.



---

Accrual basis accounting conforms to the Generally Accepted Accounting Principles (GAAP), which may be a requirement for the organisation when applying for external funding.

## **6. Disadvantages of accrual accounting**

Perhaps the most commonly cited disadvantage of accrual accounting is that it is a more complex method of bookkeeping and it can give an inaccurate portrayal of the organisation's short-term financial situation. Because of the additional complexity and paperwork to the financial reporting process, many organisations and businesses view it as a more complicated and expensive methods to implement. Since accrual basis accounting records revenues before cash is actually received, cash flow has to be tracked separately to ensure that bills can be covered from month-to-month; a business can appear to be very profitable while in reality it has empty bank accounts. Accrual basis accounting without careful monitoring of the cash flow can have potentially devastating consequences.

## **7. The effects of cash and accrual accounting – an example**

Understanding the difference between cash and accrual accounting is important, but it's also necessary to put this into context by looking at the direct effects of each method. In the following example we can see how cash and accrual accounting affect the bottom line differently.

### **Imagine you perform the following transactions in a month:**

1. Sent out an invoice for \$5,000 for work on a project completed this month
2. Received a bill for \$1,000 from a contractor for work done this month
3. Paid \$75 in fees for a bill you received last month
4. Received \$1,000 from a client for a project that was invoiced last month

### **The effect on cash flow**

Using the **cash basis method**, the profit for this month would be \$925 (\$1,000 in income minus \$75 in fees).

Using the **accrual method**, the profit for this month would be \$4,000 (\$5,000 in income minus \$1,000 in contractor's fees).

This example displays how the appearance of income stream and cash flow can be affected by the accounting process that is used.



---

## **8. How do you choose whether to use cash or accrual basis accounting?**

Cash basis accounting is generally only used when a company or organisation has no more than \$5 million of sales each year (as recommended by the IRS). It is easy to account for transactions using the cash basis, since no complex accounting transactions such as accruals and deferrals are needed. Given its ease of use, the cash basis is widely used in small businesses and non-profits. However, the relatively random timing of cash receipts and expenditures means that reported results can vary between unusually high and low profits. The cash basis is also commonly used by individuals when tracking their personal financial situations.

The accrual basis is used by all larger companies and organisations, for several reasons. First, its use is required for tax reporting when sales exceed \$5 million. Also, a company's financial statements can only be properly audited if they have been prepared using the accrual basis. In addition, the financial results of a business under the accrual basis are more likely to match revenues and expenses in the same reporting, so that the true profitability of an organisation can be determined.

## **9. Conclusion**

The decision as to whether the ICAC should use cash or accrual basis accounting depends very much on the following;

1. **Simplicity versus complexity.** Cash basis accounting is very easy to understand whereas accrual basis requires some financial accounting knowledge. From a staffing perspective it means the difference between employing a bookkeeper or an accountant and the financial consequences of each. From the standing committee's perspective, it means making a decision as to whether understanding the organisations solvency is sufficient compared to whether knowing its profitability and understanding trends is more important. One argument is that the accounts are so simple that working out cashflow and profitability are relatively easy to do.
2. **Profitability as a KPI.** For cash basis accounting profitability cannot be used as a key performance indicator. Therefore, other financial indicators such as revenue generation will need to be adopted as indicators of the organisation's growth and success.
3. **Grant funding.** As the ICAC seeks to generate more revenue from projects, many of which will be from large UN and governmental organisations, they will seek reassurance that the ICAC has adopted international accounting procedures and is properly audited.



4. Other similar international commodity bodies use cash basis accounting for ease of accounting.

It is requested that the Steering Committee give any comments which can aid the decision-making process and can also form the basis of a fuller discussion at the next Standing Committee meeting, where delegates will then make the final decision whether to keep the current cash basis system or change to an accruals system.

**Kai Hughes**  
**Executive Director**