SMALL AND MEDIUM-SIZED ENTITIES BETWEEN THE ACCRUAL BASIS OF ACCOUNTING AND CASH ACCOUNTING

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Abstract

Should revenue be recognized when generated or when ultimately collected by a company? Should expenses be recognized when incurred or when finally paid? The answers to these questions vary and are dependent or whether a entities employs the cash or accrual basis of accounting. The cash basis of accounting focuses on the cash flows connected with revenue and expenses. But the cash basis of accounting is criticized as not being in accord with economic reality. The accrual basis of accounting overcomes the chief limitation of the cash basis – a possible mismatch of revenue and expenses.

Keywords: Cash accounting, accrual bassis of accounting, IFRS Project, financial statements, cash-flow

JEL Classification: M21, M41

Intoduction

At international level, IFRS has elaborated „***The IFRS Project for SMEs***". One of the objectives of this project is to create a single set of accounting standars to stand at the base of the „production" and at the constant flow of high quality informations, clear and compatible in finanacial situations and in other financial reports created for SMEs. As shown in the standard, often SMEs create financial statements for the sole use of the proprietors – directors or for fiscal reporting or in other reglementary ways that don't relate to the value titles. In the IFRS spirit, these reports are circumscribed only to these purposes cannot be accepted as general purpose financial statements.

The adoption authority of „*The IFRS Project for SMEs*" belongs to the national settlement institutions and normalizers. As shown in „*The IFRS Project for SMEs*" it is conceived to be used by **small and medium-sized enterprises** (SMEs). SMEs are enterprises which:

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(a) do not have a ***public responsability.***

(b) publish ***financial situations with general purpose*** *for external users. External users examples includ proprietors which are not involved in conducting the activity, existing and potential creditors and as well the rating agencies.*

An entity has a public responsability if:

(a) it advanced or is about to advance **it's own financial statements** towards a value titles commity or to any other settelment organism for the purpose of emiting any class of instruments on a public market; or

(b) it owns assests in fiduciary quality for an external group, like a bank, an inssurance company, a broker/dealer of value titles, a pension fund, a mutual fund of investments or a banking society of investments.

This standard [project] doesn't acknowledge normalising value if an entity which has public responsability utilizes it for the making and presenting of financial statements, these won't be described as in conformity with the *IFRS for the SMEs* – even if the legislation or the national rulings allow that this standard [project] to be used by entreprises that have a public responsability.

The project IFRS/SMEs is based in its esence on the accounting objectives, principles and treatments formalised in the "*IFRS Network*". The esence elements regarding the recognition and evaluation, the options of accounting politics, the presentation and interpretation of the informations presented in the IFRS network are at home in the IFRS/SMEs, with some simplifications, of course.

Amongst the fundamentals of the „*IFRS Network*" assumed in the IFRS/SMEs Project the accrual basis of accounting can be found. "*An entity will constitut its financial statements, with the exception of the treasury information flux, utilising the accrual accounting. According to the accrual accounting, elements are acknowledged as assets, liabilities, own capitals, income and expenses (elements of financial statements) if they respect the definitions and the criterias of recognition for those elements*".

IFRS/SMEs Project contains the following recognition rules:

(a) an asset is recognized in the balance sheet when probably future economical benefits will be generated towards the entity and the asset has a cost or a value that can be evaluated in a credible way. An asset is not recognized in the balance sheet when an expense was commited, an expense for which it's considered unlikely that benefits will be generated towards the entity outside of the curent accounting period. Instead, a transaction of this kind generates the recognnition of other expenses in the profit and loss account.

(b) an entity recognizes **a debt** in the balance sheet when: 1.it is likely that the deduction of a present obligation might lead to an outflow of resources which incorporates economical benefits 2. and when the value level at which the settlement can be evaluated in a credible way.

(c) the recognition of the **income** results directly from the recognition of the assets and the liabilities. An entity will recognise the income in the profit and loss account when an increase of the future economical benefits was generated, benefits which are afferent to the growth of an asset or to the decrease of a debt - and this growth can be evaluated in a credible way.

(d) the recognition of **expenses** it's also a direct result of the recognition and evaluation of assests and liabilities. An entity will recognise expenses in the profit and loss account when a decrease of the future economical benefits was generated, afferent to the decrease of an asset or to the increase of a debt - and this decrease can be evaluated in a credible way.

(e) profit or loss represents the arithmetical difference between income and expenses. It is not a separate element of the financial statements and it's not necessarily a distinct recognition principle of it.

(f) this [project] standard doesn't permit the recognition of the elements from the balance sheet which don't fulfil the definition of asset or debt, regradless if they are a result or not of the application of the notion, generically called, „the concept of correlation".

Some elements regarding the area of applicability definitory for the *IFRS/SMEs Project*:

(a) *the area of applicability,* small and medium-sized entities as entreprises which:

(a1) don't have public responsability and

(a2) publish general purpouse financial stuations for external users (proprietors which are not involved in conducting the activity, existing and potential creditors, as well as rating agencies);

(b) the concepts and general principles are the ones found in the IFRS Network (the objectives of financial statements, the qualitative characteristics of the information within the financial statements, elements recognition and evaluation in financial statements, etc.);

(c) the convention of accrual basis of accounting in element recognition, with the exception of the treasury flux when developing financial statements, and, mainly, the probability to produce economical benefits and credible evaluation;

(d) the formation and content of financial statements, mainly, the balance-sheet, the profit and loss account, the modification situation of own capitals, the situation of cash flows and notes (containing a summary of notable accounting policies and other important informations);

(e) individual financial statements that are consolidated in the case of the group formed by a **mother** entity and its **branches**; the consolidation methodology;

(f) accounting politics, estimates and errors; the selection, the applying and the modification of accounting policies;

(g) the accounting of financial assets and financial liabilities, risk coverege accounting; **(h)**considerations regarding their real value;

(i) stock accounting; investments in associated entities; investments in joint ventures; real-estate investments; corporal capitals; non-corporal capitals other than the comercial fund; entreprise combinations and comercial fund; leasing contracts; provisions and contingents; own capital; incomes; government subsidies; payments in stocks; depreciation of non-financial assets; employee benefits; taxation of profits; financial reporting in hyperinflationary economies; currency conversion; segment reporting; events occuring after the end of the reporting period; disclosure of related parties; earnings per share; specialized industries (agriculture); discontinued operations and assets held for sale; interim financial reporting.

Cash accounting for SMEs. Project proposal

The IFRS project as described in the above version, based on accrual accounting, offers a complete version of accounting, preparation, presentation, financial analysis and interpretation of financial statements. Although financial statements must be complete they also must respect the threshold of meaning and cost. In our view, given that there are a variety of structures on sites SMEs, bigger or smaller, with single or complex activities, the accounting, the preparation and presentation of financial statements are not included, in all cases, in the restriction of <<*the equilibrium between benefits and cost*>>.

The project we propose addresses especially small and medium-sized entities performing singular activities (e.g. production and sale of products) or with a low volume of transactions and events. The decision to choose between IFRS project, that we call *Accrual accounting,* and the project proposed by us, called the *Cash Accounting* belongs to the management of the entity.

Forcing the note in relation to the size of small and medium entities and their position on financial and goods markets, the solution of a simplified joint reporting can be accepted: *commitments - cash*. We are not excluding the option that certain categories of entities can produce only *tax reports*.

Cash accounting is based on cash flows defined by the relation of balance between receipts and payments. At the time for activity closure, based on the intermittent inventory for material goods, receivables, liabilities and own capitals instruments, the three financial statements are built, which we consider crucial for SMEs: *the balance sheet, the profit and loss account and the cash flow situation.*

The specific scheme for this type of accounting models is presented at pag 4-5.

Organizing the cash accounting system is based on the following categories of records:

a) *The accounting book – general log* for the chronological record of all documents;

b) *The accounting book – log of proceeds and payments* in which are recorded chronologically, day by day, operations of proceeds and payments based on documents in proof. In our opinion to achieve this book-log, separate management of two logs is necessary, respectively, the *log earnings* and the *log payments*.

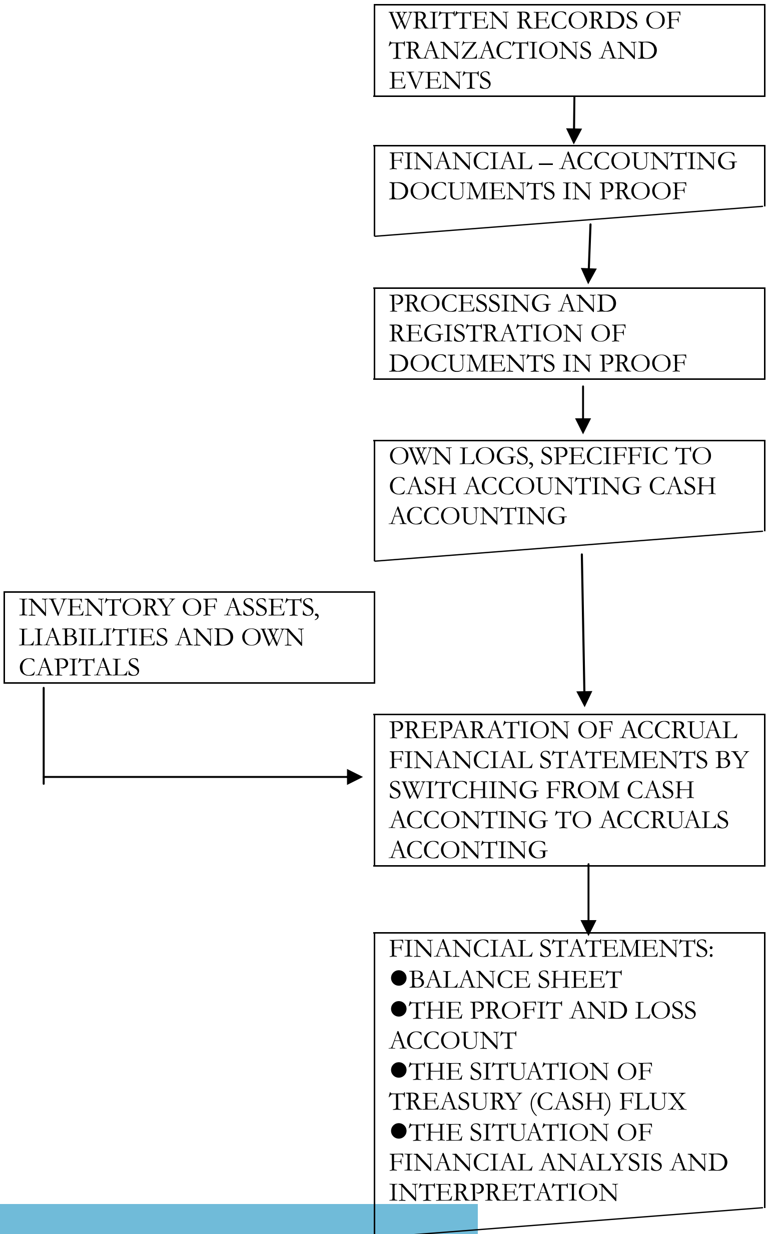
c) the *General selective ledger*, only in case of emergency, e.g. in the case of personnel expenses.

Recording transactions in cash accounts is based on double counting. The types of records differ on the nature of revenue/proceeds and expenses/payments. All records are be made in the two logs, in the *earnings* one, and, in the *payments* one.

Thus, the recording of the sales is accomplised through the relation:

xx € *Salaries Proceeds* *or* = *The Register* xx €

Since in the flow of the Wages account the net paid salary is recorded, in a corresponding way te salary deductions should be reflected. To this end, a ledger is open for the Payroll in which all the componenets for salaries are registered. From the salary deductions the following formula is assembled:



xx € *‚Cash' or bank account* = *Sales* xx €

Purchasings generate the registration ,

xx € *Purchasing* = *‚Cash' or Bank account* xx €

Wages registration,

xx € *Wages* = *‚Cash' or Bank account* xx €

For the contributions to social security and social protection,

xx € *Social securities and Social protection* = *Register or Bank account* xx €

Expenses on taxes and fees are recorded as:

xx € *Taxes and fees* = *‚Cash' or Bank account* xx €

Contributions to the extrabudget funds generates the following registration:

xx € *Extrabudget funds* = *‚Cash' or Bank account* xx €

Expenses on works and services received from third parties are registered through the formula:

xx € *Works and services* = *‚Cash' or Bank account* xx €

The purchase of fixed assets is recorded at the payment regulation through the formula:

xx € *Fixed assets* = *‚Cash'/ Bank account or Loans* xx €

Simultaneous, for the received loan, the following registration is made

xx € *Register or Bank account* = *Loans* xx €

Based on the receipt and payment register, *accounts (statements) of receipts and payments* are made montly and annualy and they are presented as such:

PROCEEDS

1	EXPLOITATION PROCEEDS		xx
	1.1.	Sales of products and goods	xx
	1.2.	Services	xx
	1.3.	Other activities	xx
	I. TOTAL EXPLOITATION PROCEEDS		xx
2	OTHER PROCEEDS		xx
	2.1.	Investments sales	xx
	2.2.	Realestate assets sales	xx
	2.3.	Short-term bank loan	xx
	2.4.	Medium and long-term bank loan	xx
	2.5.	Mortgage loan	xx

	2.6.	Contributions of capital	xx
	2.7.	Intrests	xx
	II. TOTAL OTHER PROCEEDS		xx
	III. TOTAL PROCEEDS		xx

PAYMENTS

1.	EXPLOITATION PAYMENTS		
	1.1.	Stock buyings	xx
	1.2.	Salaries, insurances and social security	xx
	1.3.	Taxes and fees	xx
	1.4.	Services received from third parties	xx
		• Commissions	xx
		• Electric energy	xx
		• Thermal energy	xx
		• Post and comunications	xx
		• Rents	xx
		• Maintenance and repairs	xx
		• Insurances	xx
		• Other services	xx
	IV. TOTAL EXPLOITATION PAYMENTS		xx
2.	OTHER PAYMENTS		
	2.1.	Purchasing of non current assets	xx
	2.2.	Short-term bank loan reembursments	xx
	2.3.	Medium and long-term bank loan reembursments	xx
	2.4.	Results sampling	xx
	2.5.	Intrests	xx
	V.TOTAL OTHER PAYMENTS		xx
	VI. TOTAL PAYMENTS		xx
3.	THE SURPLUS (THE DEFICIENCY) OF PROCEEDS OVER PAYMENTS		xx

According to the principle of practice independence, the criteria used to recognise the expenses and incomes by the result of practice, can only be that of engagement. Incomes are registered in the moment of their acquiry, and expenses while they get engaged. Accounting on such a base is encoded under the name **accrual basis of accounting.**

Interpreting incomes, according to the above criteria, makes the income independent of proceed and leeds to to its registration prior to the moment of proceed. By correspondance, starting from the principle of expenses belonging to the incomes, meaning expenses represent a cost used for obtaining an income, implicitly expenses are dissociated from payments.

Still, at the base of interferences between real fluxes (incomes and expenses are associated to the movements of goods and services) and monetary fluxes (proceeds and payments), the accounting result can be calculated based on a **cash accounting.**

Starting with the *log of proceeds and payments* and with the *lodges*, to which the of *assets and liabilities inventory* can be added, the *account of profit and loss* can be generated. The calculation relations are based on the balance that can be settled between incomes-expenses and proceeds-payments. For this purpose a balance of regularizations is made, as such:

SPECIFI-CATION OF THE EXPENS-INCOME	PAYMENTS - PROCEEDS	BALANCE VARIATION LIABILITIES/ RECOVERABLE DEBTS	EGAGED EXPENSES/ INCOMES	OBSERVATIONS
0	1	2	$3 = 1 \pm 2$	4

The recap of expenses and incomes in this situation is made according to the positions in the profit and loss account.

In relation to the nature of incomes and expenses, the transfer of proceeds in incomes and of payments in expenses is presented this way:

a) sales incomes

■ registration in the proceeds log

‚Cash' = Sales
or
Current accounts in banks

■ determination of incomes from sales

● *Cashed in incomes*
(+) *Final balance of recoverable debts towards the clients*
(—) *Initial balance of recoverable debts towards the clients*
(+) *The sums received in advance at the end of the period*
(—) *The sums received in advance at the beginning of the period*

(=) *Incomes from sales*

In a similar way the other cashed incomes other then the ones from the sales, like onoraries, rents, intrusts etc.

b) expenses regarding stored consumptions or sold stocks

■ registrationin the payment log

Stock buyings = ‚Cash'
or
Current accounts in banks

■ determination of expenses regarding the stored consumptions or the sold consumptions

● *Payments regarding stocks buyings*
(+) *Final balance of liabilities towards the suppliers, from stock buyings*
(-) *Initial balance of liabilities towards the suppliers, from stock buyings*
(-) *Sums paid in advance at the end of the period*
(+) *Sums paid in advance at the beginning of the period*
(+) *The initial stock of raw materials, materials and goods*
(-) *The final stock of raw materials, materials and goods*

(=) ***Expenses on raw materials, materials and goods***

c) Expenses with works and services received from third parties, the problem is resolved in a similar way to stocks buyings

d) Expenses on taxes, fees and assimilated payments, personnel expenses şi **other payments generating expenses,** the evaluation is conducted on the base of the balancing relation:

Engaged		Paid		Final balance		Initial balance
	=		+		-	

Remark. For salaries expenses it shall be added – reduced the variation of wages deduction, exclusively the advance that appears under ‚cash' net payments.

e) Expenses and incomes which do not generate fluxes of proceeds and payments, like in the case of amortisations and provisions, they are evaluated on the base of inventory of assets and liabilities. In this regard it's stated that separate inventory lists will be made for the depreciated goods, unusable or deteriorated, not getting sold or unmarketable, abandoned or suspended current orders, also for recoverable debts and incert obligations or disputed. As regarding the amortization, it will be evaluated on the base of the ‚*tangible fixed assets chart*' which is going to be mandatory completed, according to the laws and norms of tangible fixed assets and intangible assets.

In order to calculate the result of commitments strarting from the cash result (based on the relation between proceeds - payments) the example below cen be used:

● *The cash result*
(-, +) *Increase/decrease of own capitals and noncurrent liabilities*
(-, +) *Increase/decrease regarding fixed assets*
(-, +) *Increase/decrease of circulating assets and the increase/decrease of current liabilities*
(-, +) *The adjustments of non-cash elements (e.g. amortizations and provisions)*

(=) ***The accruals accounting of Profit (Loss) before taxation***

The balance sheet of the financial position is built on the base of assets, liabilities and tools for own capitals inventory.

Simplification regerding financial statements speciffict to cash accounting. Proposal

According to the global standard "*The IFRS/SMEs Project*", financial statements created by small and medium-sized entities include:

- balance sheet (situation of the financial position)
- the profit and loss account (situation of the global result)
- situation of own capital modification
- situation of cash flow
- notes, containing a summary of meaningful accounting politics and other explanatory informations.

Accounting regulations according to the european directives, aproved by the *Order of the Minister of Finances n° 1752/2005*, pass the next set of financial statements for smal and medium-sized entities (which on the date for the balance sheet do not exceed the limits of two of the following criterias: total of assets is 3.650.000 euro; the net turnover is 7.300.000 euro; the average number of employees during the accounting period: 50):

- shortened balance sheet;
- profit and loss account;
- simplified explanatory notes to annual financial statements;
- optional, they can prepare the situtation of own capital modification and/or the cash flows situation.

To simplify the set of financial statements we propose an option according to which a sole financial statement can be produced; we called this option ‚The situation of financial position and performance'. At the same time, an explanatory note to the financial statement' shall be developed, that represents economic-financial indicators, specific and relevant. Such a proposed situation does not exclude developing and presenting cash flows, as well as explanatory notes regarding financial analysis and interpretation of informations.

The pattern of financial position and performance situation it's presented as follows:

The situation of financial position and perfomance - proposal
-simplified-

EXPENSES FROM ASSETS, CAPITALS AND LIABILITIES	INCOMES FROM ASSETS, CAPITALS AND LIABILITIES
1.Assets to "N-1"	1.Own capitals to "N-1"
1.1. Fixed	1.1.Social capital
1.2. Circulating	1.2.Other own capitals
2. Expenses	2.Liabilities to "N-1"
2.1.Exploitation	2.1.Short term
2.2.Financials	2.2.Long term

3.Payments	3.Incomes
3.1.Expoitation activity	3.1.Exploitation
3.2.Financing activity	3.2.Financials
3.3.Investment activity	4.Cash-ins
4.Own ccapitals to "N"	4.1.Exploitation activity
4.1.Social capital	4.2.Financing activity
4.2.Other own capitals	4.3.Investment activity
5.Liabilities to"N"	5.Assets to "N"
EXPENSES FROM ASSETS, CAPITALS AND LIABILITIES	**INCOMES FROM ASSETS, CAPITALS AND LIABILITIES**
5.1.Short term	5.1.Fixed
5.2.Long term	5.2.Circulating
6.Result to "N" (+,-)	
7.Net cash to "N" (+,-)	
TOTAL	TOTAL

On the base of structures and elements from the financial statement economical-financial indicators can be calculated, specialised in the fina the financial position and in the financial performance of the entity. In a particular way, it presents the two resulting indicators: the net result of commitments and the net cash result, by appealing to the fundamental equations of accounting.

(a) the general ecuation

- *Assets to „N-1"*
- \+ *Expenses*
- \+ *Payments*
- \+ *Own capitals to „N"*
- \+ *Liabilities to „N"*
- ± *Resulted to „N"*
- ± *The net cash flow to „N"*
- = *TOTAL EXPENSES WITH ASSETS, OWN CAPITALS AND LIABILITIES TO „N"*

- *Own capitals to „N-1"*
- \+ *Liabilities to „N-1"*
- \+ *Incomes*
- \+ *Cash-ins*
- \+ *Assets to „N"*
- = *TOTAL INCOMES FROM ASSETS, OWN CAPITALS AND LIABILITIES TO „N"*

(b) calculation result:

● *Incomes*
- *Expenses*
= *Result*

or:

● *Own capitals to „N-1”*
+ *Liabilities to „N-1”*
+ *Cash ins*
+ *Assets to „N”*
- *Assets to „N-1”*
- *Payments*
- *Own capitals to „N”*
- *Liabilities to „N”*
= *Result*

(c) the calculation of the net cash flow:

● *Cash ins*
- *Payments*
= *The net cash flow*

or:

● *Own capitals to „N-1”*
+ *Liabilities to„N-1”*
+ *Incomes*
+ *Assets to „N”*
= *Total incomes*
- *Assets to „N-1”*
- *Expenses*
- *Own capitals to „N”*
- *Liabilities to „N”*
= *Net cash flow*

Conclusion

This article presented in the above chart in conceived on the base of economical criteria. Whithin it, the expenses of the periond are grouped in relation to their nature, on phases of the economical circuit – supplying, production and sale A distinctive position hasn't yet been created for the sale phase, because actual expens structures executed in this phase represents, actually, represents a continuation of the production process in the sale area.

In designing of the overall situation, was also considered the necessity of its use to commensurate the obtained results by entreprises, expresed through the *value of the net production;the value of the sold goods production (the net turnover), the increase or decrease of circulating assets.*

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