

Application of Accrual and Cash Accounting: Implications for Small and Medium Enterprises in Metro Manila

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This study aims to determine which between the two methods of accounting, accrual or cash method, is more applicable to SMEs in Metro Manila. Accordingly, this study aims to determine the factors that influence SMEs in Metro Manila to apply the chosen accounting method. Some implications of using accrual and cash accounting are specified. This includes implications on qualitative characteristics of financial information, on income statements and balance sheet, on SMEs' liquidity and profitability positions, and implications of using cash/modified-cash basis converted to accrual basis at year-end. The results of the study provide insights on the applicability of the Exposure Draft, as to the bases of accounting. This study is also timely as the final standards are expected to be issued by the IASB in the second half of 2008.

Keywords: Accrual accounting, cash accounting, generally accepted accounting principles

INTRODUCTION

The use of high quality and globally adopted financial reporting structures based on international accounting standards promotes full disclosure and transparency. It likewise facilitates the delivery of financial information that is comparable and reliable, not only across companies but across countries as well.

Companies are expected to address and disclose those things that management anticipates to have material effect on financial statements and the accounts contained therein.

Users of financial reports focus on earnings as well as on the financial condition of the enterprise. To measure an organization's performance and reflect its financial condition, two accounting methods are commonly used: accrual accounting and cash accounting. The accrual method

recognizes revenues and expenses in the accounting period in which they are considered earned and incurred, regardless of the inflow or outflow of cash. On the other hand, the cash accounting method recognizes revenue when cash is received and recognizes expenses when they are paid.

Generally accepted accounting principles (GAAP) require the use of the accrual method of accounting. However, there is a question of whether GAAP is applicable to small and medium enterprises (SMEs), and whether GAAP meets the needs of these companies, as well as of the preparers and the users of their financial reports.

This study examines whether or not SMEs comply with GAAP, and aims to determine which method of accounting is more applicable to SMEs in Metro Manila. This study also aims to determine the factors that influence small and medium scale

enterprises (SMEs) in Metro Manila to adopt one or the other accounting method. Most of the studies pertaining to accounting standards and practices applicable to SMEs have focused on developed countries (IFAC, 2006). No literature was found on the financial reporting of SMEs in the Philippines. Considering that this research is pioneering, participation of SMEs included in the study is only limited.

This study specifies some implications of using accrual and cash accounting. It includes implications to qualitative characteristics of financial information, to income statements and balance sheets, to SMEs' liquidity and profitability positions, and implications of using cash/modified-cash basis converted to accrual basis at year-end.

The results of this study provide insights on the applicability of the published Exposure Draft of an International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs). This study is timely, as the final standards will be issued by the International Accounting Standards Board in the second half of 2008.

Scope and Limitations

Considering that this will be the first study to provide insights on the applicability of the Exposure Draft to SMEs in Metro Manila, participation of these SMEs is limited. The accounts in the financial statements are limited to the components of the balance sheet and the income statement. The study only deals with the provision of the Exposure Draft as to the basis of accounting. Hence, it does not deal with the provisions regarding the timing of recognition and measurement of the elements of financial statements.

Capitalization was used to categorize the SMEs under the study. According to Republic Act No. 9178, SMEs are considered small if they have assets ranging from Php3,000,001 to Php15,000,000. Medium scale enterprises are those with more than Php15,000,000 to Php100,000,000 worth of assets.

FRAMEWORK OF ANALYSIS: COMPLIANCE THEORY

This study is grounded on the compliance theory of Raustiala (2000). This theory is relevant in the context of adherence of SMEs to accrual accounting as prescribed by GAAP. Raustiala (2000) grouped compliance theories into rationalist and normative models. Rationalist models focus on deterrence and enforcement to prevent non-compliance by changing the calculation of benefits and costs. Meanwhile, normative models focus on cooperation to prevent non-compliance.

Under the rationalist model of Raustiala (2000) called the deterrence theory, costs open up a range of enforcement options and address the corporate non-compliance with domestic rules. Cost to the firm is relevant to the SME's option of corporate compliance or non-compliance to GAAP rules of accrual.

Another rationalist model described by Raustiala (2000) is the behavioral decision theory, which acknowledges that people act according to their rational calculation of how a particular choice is framed. The awareness of the accrual and cash bases of accounting sets the frame of choice between the two methods to be applied.

On the other hand, one of the normative models of Raustiala (2000), called the complexity critique, focuses on the capacity of the regulated firm. Complexity charges regulations as too numerous, too difficult to understand, and too fluid or ever changing. This would particularly be the case for SMEs, which generally lack the resources to stay apprised of complicated, changing regulatory requirements. In addition, Trinidad (2006) concluded that there are companies in Metro Manila that use cash basis of accounting, then convert to accrual basis for purposes of reporting and compliance only.

IMPLICATIONS OF ACCRUAL AND CASH ACCOUNTING

Accrual accounting recognizes expenses when an obligation arises, and not simply when cash is

paid. Similarly, revenue relates to the entity's entitlement to future benefits, and not the point at which cash is received. While accrual accounting is preferred to cash accounting, cash measures are still relevant. One implication of accrual financial statements is that the user cannot understand a firm's cash flow, cash utilization, and cash needs by the income

Implications on Characteristics of Financial Information

The objective of financial statements is to provide information that is useful to a wide range of users in making economic decisions. Financial statements should be understandable, relevant, reliable, and comparable. Accrual accounting incorporates non-cash information such as revaluations, write-offs, the consumption of assets through depreciation, and pension liabilities.

On the other hand, the cash method only recognizes accounts resulting from cash transactions. Non-cash accounts such as receivables and payables arising from the ordinary course of the business are not recorded. Hence, cash basis of accounting does not provide a complete financial picture of the SME, in the same way the accrual method does. Therefore, information provided under the cash method may not pass the qualitative characteristics of being relevant and reliable.

Implications on Income Statements and Balance Sheets

The economic resources an enterprise controls, its financial structure, its liquidity, and its solvency affect its financial position. The balance sheet presents these kinds of information. Meanwhile, performance is the ability of an enterprise to earn a profit on the resources that have been invested in it. Information about performance is primarily provided by the income statement.

The cash method of accounting often produces misleading financial statements. It fails to record revenue that has been earned but for which cash has not been received. In addition, expenses are not matched with earned revenues. Cash basis income statements can be misleading because it

can: (a) *understate net income* when producing commodities not yet sold for cash and when paying for inputs used in a different accounting period; and (b) *overstate net income* when receiving cash for commodities not produced in current accounting period, and when using inputs paid for in a different accounting period.

Implications on Liquidity and Profitability Positions

Users of financial statements are normally interested in the liquidity and profitability positions of the entity. An entity must maintain sufficient liquidity to ensure safe operations and to avoid a drop in confidence from the users of financial reports. Profitability on the other hand, is one way of presenting the ability of a business firm to control expenses and operate profitably. A company's ability to manage costs, operate efficiently, and turn consistent profits have obvious positive implications for cash flow and payment ability.

Under the cash method, receipts and disbursements are recorded when they result from cash transactions. As a result, certain assets and their related revenues (e.g. accounts receivable and revenue for billed or provided services not yet collected) and certain liabilities and their related expenses (e.g. accounts payable and expenses for goods or services received but not yet paid) are not recorded in these financial statements, in contrast to accrual accounting.

Therefore, the cash method cannot provide information reliably and accurately to test the liquidity and profitability positions of an SME, as the accrual method does.

Implications of the Use of Cash Method, Converted to Accrual at Year-end

Some SMEs use cash method and convert to the accrual basis at year-end for GAAP compliance purposes.

Accounts converted to accrual at year-end provide historical information for transactions during the year. Thus, the conversion to accrual does not serve its purpose where decision-making is concerned. This is especially crucial if the entity is

suffering from unbearable losses, which will be realized only after the conversion process. Accrual-based financial statements (which are to be used for decision-making) should be prepared concurrently, say on a regular monthly basis, not historically.

FACTORS AFFECTING COMPLIANCE

The set of globally recognized accounting standards and procedures relating to the presentation of financial statements are called International Financial Reporting Standards (IFRS). When the International Accounting Standards Board (IASB) sets a brand new accounting standard, a number of countries tend to adopt the standard, or at least interpret it, and fit it into their individual country's accounting standards. These standards, as set by each particular country's accounting standards board, will in turn influence what becomes generally accepted accounting principles (GAAP) for each particular country.

GAAP are imposed on companies so that investors have at least a minimum level of consistency in the financial statements they use when analyzing companies for investment purposes. Accordingly, the constant evolution of GAAP, therefore, fulfills its mission to disseminate quality financial information. This information obtained from the financial statements, earnings in particular, facilitates investors' valuations and the monitoring of management.

The issue of the application of accounting standards to small and medium enterprises has been the subject of numerous studies around the world (Allister, 1995). Fundamentally, general-purpose financial statements are prepared on the assumption that there are no basic differences in the needs of those who will use them.

However, small companies' accounts are prepared primarily for the benefit of owner-managers, their bankers and the revenue authorities who have little interest in the kind of information aimed at users of public companies' statements. The board of directors or other equivalent governing body controls the circulation of financial statements of non-public entities (Mersereau,

2002). Such financial statements are generally restricted to management and lending institutions.

Jankovic (2007) enumerated several reasons why the application of IFRS is inadequate. These are (1) users of SMEs' financial statements need less information compared to the users of financial statements of listed companies; (2) particular transactions mentioned in IFRS occur seldom, if ever, in SMEs; (3) the cost/benefit ratio of financial reporting is more favorable in large companies than in SMEs; and (4) IFRS are prone to changes unlike national standards, which results in higher costs of IFRS implementation.

A survey sponsored by the American Institute of Certified Public Accountants (AICPA) revealed that respondents said that certain GAAP standards are not relevant and useful enough to help SMEs make management, credit, and investment decisions (Tie, 2005). Alerding (2003) believed that SMEs have been caught in the wake of increasingly complex accounting and disclosure requirements following the wave of laws and new accounting pronouncements, resulting from the Enron scandals and similar frauds.

Consequently, The Financial Accounting Standards Board (FASB) continues to address the complexity of the GAAP hierarchy in the standards it has issued (Fitzsimons & Thompson, 2005).

Ever so often, debate arises as to whether separate accounting and reporting rules should be set for SMEs (Sayther, 2004). The debate has risen as to whether SMEs should adopt a different set of accounting rules due to reasons such as differing needs of financial users, rapid and widespread developments in financial reporting, compliance costs, and statutory requirements (Mersereau, 2002).

The debate has generally revolved around one principal issue: whether accounting standards should apply equally to all financial statements that purport to present a true and fair view, or whether small companies should be exempted from the unduly burdensome requirements of certain standards (Allister, 1995).

Tom Kelly of AICPA says that there is a widespread complaint that accounting standards

are too big and too complicated for SMEs (Cheney, 1995). David Sun Tak-Kei, president of the Hong Kong Society of Accountants (HKSA), believes that many of the accounting rules are tailored for large companies. Hence, HKSA took the initiative to introduce accounting standards tailor-made for SMEs in a bid to help them save time and money (Yiu, 2003).

In the United States, owners of private companies argued that external users of financial statements do not utilize all the information contained in such reports. The extra costs incurred by such private entities were not worth the benefits received. In 2002, U.S. Small Business Administration reported that companies with 20 or less employees were spending an average of USD1,202 per worker to comply with federal financial reporting mandates. Such amount was more than twice the amount that companies with more than 500 workers spent on compliance (Sayther, 2004).

Nevertheless, the U.S. released revenue regulations to ease the burdens of SMEs. Revenue Procedure 2000-22 allows any company, with tests to meet, to use cash method of accounting for tax purposes. Revenue Procedure 2002-28 was issued in May 2002 to reduce administrative and tax compliance burdens and to minimize disputes over the use of the accounting method because of the requirement to account for inventories (Chiavetta, 2002).

The United Kingdom's Accounting Standards Board has published Financial Reporting Standard for Smaller Enterprises, which provides a complete compendium of simplified versions of UK standards applicable to private companies that meet certain statutorily established conditions based on revenue (currently 22.8 million), total assets (11.4 million) and average number of employees (50) (Martin, 2000).

In Canada, some companies opted to depart from certain GAAP requirements and settled on qualified audit or review reports, or moved from audited or reviewed statements to compilation engagements just to minimize the cost of engagements (Mersereau, 2002).

Meagher (1982) stated that SMEs in Canada conform to the same standards as large businesses but the way in which financial statements are being

prepared, to them, is simply too complex. Thus, the Canadian Institute of Chartered Accountants (CICA) considered three conceptually different accounting models: (1) a single set of GAAP without exclusions, essentially the status quo; (2) a single set of GAAP with exclusions for SMEs; and (3) two distinct sets of GAAP. The primary rationale for the exclusions was to reduce SMEs compliance burden (Feltham & Mathieu, 2000).

Furthermore, the CICA Accounting Standards Board commissioned a research to examine how the financial information needs of capital to SMEs might be more effectively met, and the degree to which reporting in accordance with generally accepted accounting principles could be modified to meet those needs (Lavigne, 1999).

The findings of the consultation process demonstrate that only one was acceptable to the SME financial reporting stakeholders consulted – the adoption of differential reporting principle within GAAP (Lavigne, 1999). According to this principle, accounting rules governing SMEs would be permitted to differ from accounting rules applicable to public enterprises when such rules do not meet the financial reporting needs of SMEs or when the cost of applying the rules would outweigh their potential benefits for these enterprises (Martin, 2000).

Carter (1981) claimed that gross benefit is achieved when the cost of producing and processing the unique information is ignored. He examined the continuing focus on benefits rather than costs of the reporting alternatives and argued that the identification of which of the alternatives fits a particular accounting policy decision should indicate costs of the policy choices.

In many cases, the cost of preparing those financial statements is increasing significantly. Sayther (2004) concluded that some companies chose to depart from certain GAAP requirements to limit compliance costs. It is believed that the costs of compliance with GAAP exceed the benefits for SMEs (Derieux, 1985).

In a study made by Meagher (1982), small businesses claim that although they are conforming to the same accounting standards as large

businesses, they argue in favor of a two-GAAP approach, one for large businesses and one for SMEs. The two-set model is consistent with accounting theory; it allows for congruence with policies for SMEs, and ensures that standards reflect important differences and needs.

. Financial statements for business organizations must be prepared using the accrual accounting basis. This requirement is specified in Philippine Accounting Standards (PAS) 1: *Presentation of Financial Statements*.

Business firms that customarily receive cash advances from customers before the rendering of services or delivery of goods may well find that the accrual basis of accounting is advantageous (Jones & Luscombe, 2002). Businesses rely on the accrual accounting method as the only source for management decision-making (Simpson, 1992).

Churchill (1992) affirms that this method is also used by most corporate and many unincorporated bodies, such as societies, associations and clubs, small government departments, and professional firms because it provides an accurate picture of the company's current condition. However, Churchill (1992) disclosed that its relative complexity makes it more expensive to implement

Chan (2003) claimed that traditionally, some governments and businesses have used different accounting methods because they have different goals. Governments prefer to use cash-based accounting to manage and report revenue and spending to a certain period. The private sector, on the other hand, needs to manage financial performance.

Carter (1981) affirmed that the choice between accrual-basis and cash-basis reporting of revenues provides an example of preference in the benefits sense. If a user of

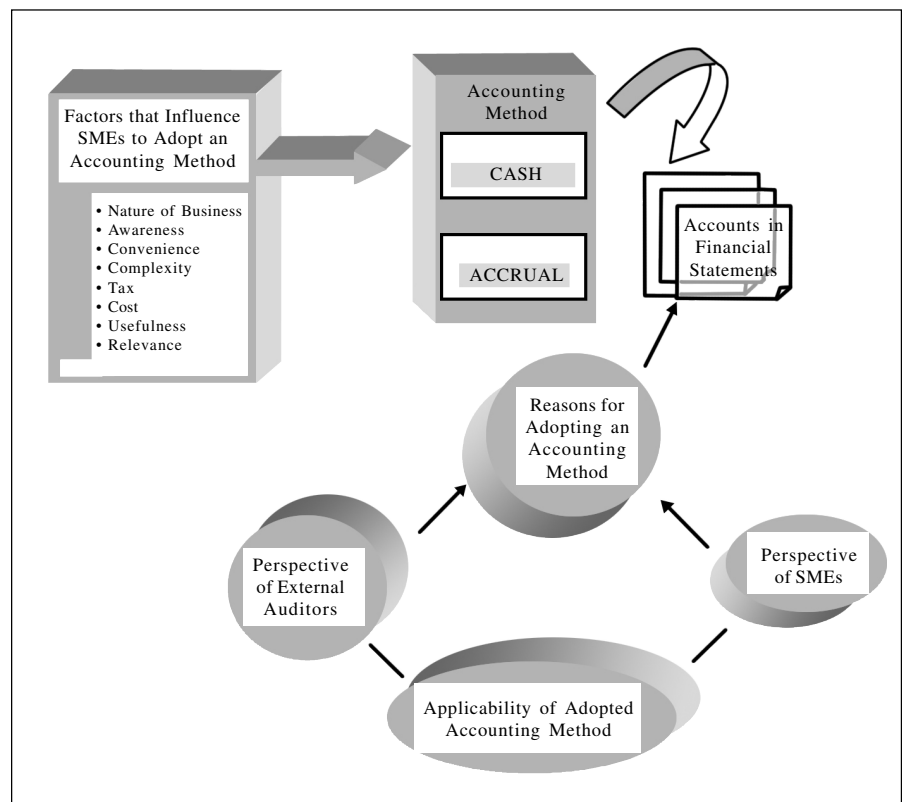
accrual-basis statements prefers that revenues be stated on a cash basis, he can simply ignore trade receivables and unearned fees on the balance sheet, and adjust reported accrual basis revenues by the differences between the year's beginning and ending balances in those two accounts, plus the reported uncollectible accounts expense. This calculation provides a cash-basis figure for revenues, and accommodates those users who prefer the cash basis to the accrual basis for reporting revenues.

FRAMEWORK OF ANALYSIS AND METHODOLOGY

Figure 1 assumes that SMEs take into consideration several factors that would influence them to choose between the two methods – accrual or cash – in the preparation of the entity's financial statements.

The two methods of accounting are used in the preparation of financial statements of SMEs in

Figure 1. Factors affecting compliance.



Metro Manila. Specific accounts were identified in using either of the two methods. Various reasons substantiate the use of the adopted method on the accounts presented in the financial statements.

The perspective of both the external auditors and the SMEs were sought to determine which between the two methods is more applicable to SMEs in Metro Manila.

Surveys were conducted and data gathered from ten external auditors handling SME clients throughout Metro Manila. The data gathered from the external auditors were corroborated by 17 SMEs in Metro Manila. Considering that the external auditors are the ones who prepare the financial statements for these SMEs, the responses gathered from the external auditors suffice to meet the objectives of the study.

The factors that influence the SMEs to use the chosen accounting method, which were measured using Likert's Profile Organization, are as follows:

1. *Nature* refers to the kind of business of SMEs, whether trading, manufacturing or service concern. This was measured with the option coded "1" when a firm considers the nature of its business in choosing the accounting method applied, and "0" otherwise.
2. *Awareness* refers to the entity's acquiring knowledge of the accounting method, its principles, as well as the generalized significance and broad applicability. This was measured as "1" when a firm is aware of the difference between cash and accrual accounting in choosing the accounting method applied, and "0" otherwise.
3. *Convenience* refers to the level of burden in record keeping. This was coded "1" when the firm considers the accounting applied as a method that eases the record keeping burdens, and "0" otherwise.
4. *Complexity* refers to the burden of accounting and disclosure requirements in reporting to regulatory bodies. This was measured using a "1" through "5" scale. The value of "5" is assigned if the firm strongly agrees to the statement that accrual requires more complex accounting and disclosure requirements; the value of "4" if the firm agrees, "3" if the firm is neutral, "2" if the firm disagrees, and "1" if the firm strongly disagrees.
5. *Tax* refers to the level of burden in compliance with tax regulations. This was coded "1" when the firm agrees that tax compliance burden is greater in accrual accounting and "0", otherwise.
6. *Cost* refers to the cost of preparing the financial statements. This was measured using a "1" through "5" scale. The value of "5" is assigned if the firm strongly agrees to the statement that the accrual method is costly; the value of "4" if the firm agrees, "3" if the firm is neutral, "2" if the firm disagrees, and "1" if the firm strongly disagrees.
7. *Usefulness* refers to the valuation of firms of the accounting method with respect to the characteristics of consistency and comparability for decision-making. This was measured using a "1" through "5" scale as to the rate of usefulness of financial statements prepared under the accrual method for decision-making. The value of "5" is assigned if the firm always uses them, "4" if the firm uses them very frequently, "3" if the firm uses them occasionally, and "2" if the firm uses them rarely, and "1" if the firm never uses them.
8. *Relevance* refers to the capacity of the information to influence a decision. This was measured using a "1" through "5" scale as to the rate of relevance of the information provided by the financial statements under the accrual method. The value of "5" is assigned if the firm considers the information very relevant, "4" if the firm considers them relevant, "3" if the firm considers them moderately relevant, "2" if the firm considers them of little relevance, and "1" if the firm considers them not relevant at all.

RESULTS AND DISCUSSION

The nature of the business of the sample SMEs and the clients of the external auditors in this study are scattered across the areas of construction, trading, pharmaceutical distribution, real estate, restaurant, communication, printing, and garment manufacturing.

Out of 17 SMEs, 13 use the accrual method. One SME uses cash method for record keeping, and regularly converts to accrual method for purposes of reporting to regulatory bodies. Three SMEs, however, use cash method, and the external auditors are tasked to prepare year-end adjustments using accrual method in accordance with GAAP.

Factors that Influence SMEs to Adopt an Accounting Method

The following were the results of the survey on factors that influence the SMEs to adopt a particular accounting method.

Nature of Business. Unanimously, SMEs considered the nature of their businesses in choosing the accounting method applied. SMEs involved in financing/pawnshops, real estate, construction, and restaurants apply the cash method. Cash basis is generally used when it is difficult to determine the revenue amount at the time of a credit sale because collection is uncertain. On the other hand, SMEs such as those involved in printing, trading, transportation services, and manufacturing concerns like garments, use accrual method. Some of these firms customarily receive cash advances from customers before they render services or deliver goods, for which reason, too, they find accrual method advantageous. In addition, reporting accounts under this method helps them to plan the operating cycle, especially in the management of inflow and outflow of cash.

Awareness. Eighteen percent of the SMEs are not aware of the difference between the accrual and cash accounting. Consequently, these SMEs use cash method; they therefore leave to the practitioners the task of converting the accounts to accrual method at year-end.

Complexity. Fifty percent of the external auditors strongly agreed that accrual accounting requires more complex reporting and disclosure requirements than the cash method. Meanwhile, 76 percent of the SMEs likewise strongly agreed (“5”) with the statement. Forty percent of the external auditors and 24 percent of the SMEs agreed (“4”) with the statement. Only six percent of SMEs disagreed (“2”) with the statement, which means that for these firms, the two methods are equal in terms of complexity in reporting and disclosure requirements.

Tax Compliance Burden. Seventy percent of the external auditors agreed that tax compliance burden is greater under the accrual method. These perspectives were validated by 76 percent of the sample SMEs. However, 30 percent of the auditors claimed that tax compliance burden has the same weight regardless of whether a client is using accrual or cash method. Likewise, 24 percent of the SMEs disagreed that tax compliance burden is greater under accrual than under cash method.

Cost. Twenty percent of the practitioners strongly agreed (“5”) to the statement that preparing financial statements under the accrual method is more costly than under cash method; but only 18 percent of the SMEs validated the perspectives of the auditors. Forty percent of the external auditors agreed (“4”) to the statement while 30 percent of them argued that the cost is almost the same under the two methods. Meanwhile, 76 percent of the SMEs were neutral to the statement, which means that they claimed that there is no difference in the cost of preparing financial statements under the two methods. The remaining ten percent of the external auditors strongly disagreed that accrual method is more costly. This was corroborated by six percent of the sample SMEs.

Usefulness in Decision-Making. Sixty percent of the practitioners claimed that their clients always utilize the financial statements under the accrual

method for decision-making, while 59 percent of the SMEs claimed the same thing. Ten percent of the practitioners said that their clients use those reports for decision-making very frequently, and 18 percent of the SMEs claimed the same. Thirty percent of the practitioners whose clients use the cash method stated that their clients never used the financial information under the accrual method in decision-making. This was validated by 24 percent of the SMEs, primarily because of

unawareness of the accrual method and thus the use of the cash method.

Relevance of Information. The respondents were asked regarding the relevance of information under the accrual method. The components of the financial statements were enumerated and the respondents ranked whether the information provided by the accounts were relevant to management, “5” being very relevant and “1” being of little relevance.

Table 1
Components of SMEs’ Financial Statements under Accrual Method with Ranking of Relevance of Information to Management

Accounts	Weighted Average	
	Perspective of Auditors	Perspective of SMEs
Assets		
Trade and Other Receivables	4.60	5.00
Inventories	4.50	4.60
Supplies	4.20	3.80
Prepayments	4.00	4.00
Property, Plant & Equipment	4.40	4.00
Liabilities		
Trade Payables	6.10	5.00
Loans Payable	4.30	4.40
Taxes Payable	3.00	
Advances from Officers	4.00	
Accrued Expenses	4.00	
Revenue		
Sales 4.86	5.00	
Service Income	4.00	5.00
Interest Income	4.00	
Expenses		
Purchases	4.70	4.40
Salaries and Wages	4.60	4.25
Taxes and Licenses	4.56	3.60
Utilities Expense	4.30	4.60
Rent Expense	4.33	
Insurance	4.00	

The results, as presented in Table 1, show that 80 percent of the practitioners claimed that the Purchases account provides information that is very relevant to management decision making. This account has direct relationship with cost of sales for a given period, as well as the inventory at the end. It also affects the liability account Trade Payables for purchases on credit as ranked by 50 percent of the practitioners. This conforms to the rate of relevance given by practitioners to accounts such as Inventories and Trade Payables.

Sixty percent of the practitioners rated Inventories as “5”, while 50 percent of them rated Trade Payables the same way. Seventy percent of the practitioners agreed that Trade Receivables rank as the next most relevant to management decision-making. Management is not only after the sales for the period but also the corresponding collectables as well. Liquidity of the company lies heavily on the turnover of receivables, as well as on inventories. Salaries Expense also ranked as the next most relevant. Seventy percent of the practitioners revealed that payment to employees comprises the bulk of expenses for SMEs, and hence it is very relevant to management in decision-making.

Results show the same ranking of accounts from the perspectives of the SMEs. Fifty-nine percent of the SMEs claimed that Trade Receivable and Trade Payables are very relevant to provide information for decision-making. The results also validate the perspective of the practitioners as to the relevance of accounts, namely, Inventories, Sales, and Purchases. Forty-seven percent of SMEs rated Inventories “5”, 41 percent for Sales, and 35 percent for Purchases.

Convenience. Seventy percent of the practitioners claimed that the accounting method chosen by their clients was due to convenience in record keeping, while 30 percent of the practitioners disagreed that convenience is one of the factors why their clients chose a particular accounting method. This was corroborated by the SMEs as 76 percent of them agreed that convenience was a factor considered in adopting

the chosen accounting method. Twenty-four percent of the SMEs, on the other hand, contradicted the practitioners by disagreeing with the statement.

Other Factors. The respondents were asked to specify other factors that are considered in choosing the accounting method applied. The practitioners consider the method that better reflects the true financial condition of their clients. They consider the method that applies the principle of proper recognition of income, and the principle of matching the revenue recognized with the expenses incurred for the period.

On the other hand, sample SMEs consider the method that is required by Bureau of Internal Revenue. In addition, SMEs consider the method that will be able to produce schedules that support the revenue during the period.

Accounts that Use Accrual Method

Appendix A presents the accounts in the SMEs' financial statements prepared under the accrual method and the reasons for using the method. Results show that 70 percent of the practitioners stated that the accounts that can be found in the financial statements of SMEs using accrual method are Trade Receivables, Trade Payables, Inventories, Sales, Purchases, and Utilities Expense.

Sixty percent of the external auditors added such accounts as Property, Plant and Equipment and Salaries Expenses. Forty percent of the external auditors added accounts such as Service Income, Loans Payable, Supplies Expense, Taxes and Licenses. Thirty percent of the external auditors further added the accounts such as Rent Expense and Prepayments. Depreciation Expense was included by 20 percent of the practitioners. Finally, ten percent of the practitioners claimed to add such accounts as Interest Income, Taxes Payable, VAT Payable, Insurance Expense and Accrued Expenses.

Likewise, the perspectives of SMEs were sought. Results show that 59 percent of the SMEs stated that the accounts that can be found in their

financial statements are Trade Payables, Trade Receivables, Inventories, Unearned Revenue, Purchases, and Rent Expense. Fifty-three percent of the SMEs added the Supplies account, while 47 percent of them added accounts such as Taxes and Licenses, Loans Payable, and Utilities Expense. Forty-one percent of the SMEs further added Sales, Prepayments, and Property, Plant and Equipment accounts. Finally, 18 percent of the SMEs added the accounts Service Income and Interest Income.

Accounts that Use Cash Method

Appendix B presents the accounts in the SMEs' financial statements prepared under the accrual method and the reasons for using the method. The ten external auditors unanimously stated that Depreciation Expense and Repairs are accounts that can always be seen in the financial statements of SMEs using cash method. Whether an SME is using accrual or cash, Depreciation Expense is necessary when an entity has acquired assets classified as Property, Plant and Equipment.

An SME using cash method recognizes the Depreciation Expense as well as the assets due to materiality in amount, and the fact that useful life of the assets extends beyond a year. This means that SMEs use modified-cash basis of accounting in considering fixed assets and the related depreciation.

Added to the list of the accounts are Sales, Purchases, and Insurance Expense, according to 30 percent of the external auditors. Twenty percent of them, however, added the accounts Salaries, Service Income, and Loans Payable. Finally, ten percent of the practitioners added to the list of accounts using accrual method, accounts such as Investments, Supplies, Utilities, Rent Expense, and Security Expenses.

On the other hand, given the perspectives of SMEs included in the study, they unanimously stated that Depreciation Expense and Repairs are always found in their financial statements prepared using the cash method. Under the cash method, in the strictest sense, the account Property, Plant and Equipment and the related Depreciation Expense

are not to be used by an entity. Nevertheless, as earlier mentioned, Depreciation Expense is necessary when an entity acquires depreciable assets. This means that SMEs using cash method have these accrual components mixed, and financial statements of this type are prepared using the modified cash basis. The Repairs account is inevitable as normally an entity incurs expenses for the minor repairs of equipment or of the office space. These expenses are treated as outright expenses because the amounts are immaterial.

Fifty-three percent of the SMEs added Salaries Expense to the list of accounts under the cash method. Forty-one percent of them also added to the list accounts such as Property Plant and Equipment, Purchases, Supplies Expense, and Insurance Expense. Furthermore, 24 percent of the SMEs added the account Sales for cash received from customers for the period. These are recognized as revenues regardless of the period when the goods were delivered. Likewise, 18 percent of the SMEs added Service Income to the list. This is income recognized at the time of cash receipt from customers, regardless of period when services were rendered.

Investments and Loans Payable accounts were added by 12 percent of the SMEs. Investments are on cash basis and necessary to be included in the asset component of Balance Sheet. Loans Payable is reported to reflect the obligation arising from loan acquired, settlement of which goes beyond a year.

Applicability of the Accrual Method

The respondents were asked regarding the applicability of accrual method, as prescribed by GAAP. The following are the comments of the respondents:

From the Perspective of External Auditors. The accrual method is applicable to SME clients because: (a) it reflects better the true financial condition of the company; (b) clients need a real picture of the business to be used as a tool in decision-making; (c) it facilitates complete monitoring of actual transaction of the business

operation for internal control purposes; (d) it reflects the net income for the period; (e) accrual method gives a more accurate picture of the companies financial situation than cash method; (f) it is needed for financial reporting purposes; (g) the nature of the business requires its use; (h) it captures correct charging of expenses at the period when revenue is earned; and (i) the matching principle of cost and revenue requires its use.

Meanwhile, the accrual method is not applicable to SME clients because: (a) given tax purposes, as in Accrued Income already earned but not yet received, the client pays taxes on this income not yet received; and (b) the client needs to withhold taxes on expenses recognized in the books, although accrued expenses can be part of allowable deductions even if not yet paid.

From the Perspective of SMEs. The accrual method is applicable to SMEs because: (a) it provides a more realistic and accurate analysis of how the company is performing; (b) it reflects the true financial condition of the firm; (c) it is mandatory; and (d) it is in accordance with accounting standards.

Meanwhile, the accrual method is not applicable to SMEs when tax purposes are taken into account.

CONCLUSION

The researcher argues that the factors that influence SMEs in Metro Manila in adopting the chosen accounting method differ from those identified in previous studies. The following conclusions are drawn:

1. Not all SMEs in Metro Manila adhere to accrual accounting as prescribed by GAAP.
2. Adherence to accrual accounting is influenced by the nature of business transactions of SMEs in Metro Manila.
3. Adherence to accrual accounting is influenced by awareness of the different accounting methods.

4. Adherence to accrual accounting is influenced by convenience in record keeping.
5. Adherence to accrual accounting is not influenced by the complexity in reporting and disclosure requirements.
6. Adherence to accrual accounting is not influenced by tax compliance burden.
7. Adherence to accrual accounting is not influenced by the cost of preparing financial statements.
8. Adherence to accrual accounting is influenced by the usefulness of the financial statements prepared under the method in decision-making
9. Adherence to accrual accounting is influenced by the relevance of information for management.

Between accrual or cash method of accounting, which, then, is more applicable to SMEs in Metro Manila?

From the data and results gathered, cash accounting is used for tax reporting purposes; and accrual accounting, for financial reporting purposes. Some SMEs prepare financial statements primarily for tax authorities, rather than for investment and credit decision-making; and thus, the preference for the cash method.

On the other hand, some SMEs rely on accrual accounting as the only source of information for management decision-making. Financial statements prepared under the accrual method are intended to meet the needs of investors, lenders, creditors, rating agencies, employees, customers, and others outside the business. The general-purpose financial statements serve the managers' needs by providing insights into the financial position, performance and cash flows of the business.

Based on these, the researcher argues that information that would make past results and present conditions a basis for prediction should be provided. Cash accounting has a variety of limitations, as discussed earlier. It does not meet the requirement that financial statements should not only serve special or narrow needs of specific

users, but rather should serve the general need of all users. Therefore, users of financial statements should be careful in making economic decisions based on the information provided from the use of cash accounting.

The researcher posits that cash-based information has the advantage of being relatively simple and readily verifiable. However, non-cash costs or revenues are not recorded. The accrual method is based on the idea of accurately presenting a firm's earned income, that is, the actual economic results of its activities, not the cash result of its activities.

The primary purpose of financial statements is to present information that will assist in estimating the value of the firm. Because it is impossible to do so without, at least implicitly, evaluating the firm's management, and vice-versa; it can be said that for financial statement information to be relevant, and thus useful, it must be in aid of the firm valuation/management evaluation process. Furthermore, to be useful, the statements must be reliable and understandable.

Financial statements are reliable when users can depend on the data contained therein to be reasonable representations of what the firm purports to be. To be understandable, such data must be, among other things, consistent with the concepts of the users and in agreement with the way they utilize the statements in making decisions about a firm or its management.

The relevant asset figure for balance sheet purposes is the real value of that asset to the owner. Thus, asset figures (and all financial statement figures) gain their relevance depending upon how these financial statements are used to estimate a firm's value and/or evaluate a firm's management.

The most relevant method, then, is the accrual basis because it best enables the statement users to estimate the real value of the firm. It reflects the actual income figure, which should give an idea of whether the value of a firm has increased or has decreased.

Based on the above results and interpretation thereof, the researcher posits further that in cash accounting, an SME considers itself profitable

when, in the long run, it will receive more cash than it will pay out. This is most clearly imaginable in the case of a trading business that buys and sells exclusively on a cash basis. If such a firm incurs losses, it is paying out more cash than is coming in from sales. It can only sustain its cash balances by injections of capital or by selling off its assets, processes that cannot be continued indefinitely.

Given the limitations of cash accounting, accrual accounting, in contrast, meets the objectives of the financial statements for being reliable, relevant, understandable, and comparable. Consequently, despite some difficulties identified by SMEs in using accrual method, they find more advantages to the use of this method, rather than cash method; as a result of which, the majority of them use the accrual method.

Therefore, the researcher posits that accrual accounting is more applicable than cash accounting for SMEs in Metro Manila. Hence, the provision of Section 2.33 of the Exposure Draft of IFRS for SMEs that requires the use of accrual basis of accounting is indeed applicable to SMEs in Metro Manila.

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Appendix A

Accounts in SME's Financial Statements Under Accrual Method and Reasons for Using the Method

Account	Auditors (%)	Reason for Using Accrual Method	SMEs (%)	Reason for Using Accrual Method
Assets				
Trade and Other Receivables	70	<ul style="list-style-type: none"> To monitor collections Evaluate status of accounts to customers To properly account sales To reflect sales on credit Due to matching principle Compliance with government rulings For complete accounting /transaction history influencing management decision- making To reflect cost of sales properly To properly evaluate status of inventories 	58.82	<ul style="list-style-type: none"> Per BIR statutory reporting guidelines To facilitate group of companies' consolidation To increase sales for sales on credit
Inventories	70	<ul style="list-style-type: none"> To take up supplies on hand as of cut-off date To reduce the cost for buying supplies 	58.82	<ul style="list-style-type: none"> To account for inventories at the end of period Per BIR statutory reporting guidelines To facilitate group of companies' consolidation To reflect unused supplies
Supplies	40	<ul style="list-style-type: none"> To record the unused portion of advance payment made To reflect actual cost in the books 	52.94	<ul style="list-style-type: none"> Per BIR statutory reporting guidelines To facilitate group of companies consolidation To record the unexpired portion of payments made
Prepayments	30	<ul style="list-style-type: none"> Matching principle Allocation of cost over the life of the assets 	41.18	<ul style="list-style-type: none"> To account properly the assets to be used in operations
Property, Plant & Equipment the	60		41.18	
Liabilities				
Trade Payables	70	<ul style="list-style-type: none"> To monitor payments and evaluate status to suppliers To take up unpaid obligations Matching principle To reflect the liability 	58.82	<ul style="list-style-type: none"> In order not to understate the purchases Per BIR statutory reporting guidelines To facilitate group of companies' consolidation
Loans Payable	40		47.06	<ul style="list-style-type: none"> Per BIR statutory reporting guidelines To facilitate group of companies' consolidation
Unearned Payable			58.82	<ul style="list-style-type: none"> To recognize the unearned portion of income recorded Because of cause and effect with cost of sales
Taxes Payable	10	<ul style="list-style-type: none"> To take up estimated tax for payment 		
VAT Payable	10	<ul style="list-style-type: none"> To take up output tax for remittance 		
Accrued Expenses	10	<ul style="list-style-type: none"> To take up unrecorded/ unpaid expenses 		

Account	Auditors (%)	Reason for Using Accrual Method	SMEs (%)	Reason for Using Accrual Method
Revenue				
Sales	70	<ul style="list-style-type: none"> To show actual sales every cut-off date To include credit sales during the period Most of client sales are on account To record income already earned To include credit income for service rendered 	41.18	<ul style="list-style-type: none"> For complete recording of sales Per BIR statutory reporting guidelines To facilitate group of companies' consolidation To include income already earned Per BIR statutory reporting guidelines To facilitate group of companies' consolidation To include interest income already credited by the bank but not recorded in the books
Service Income	40		17.65	
Interest Income	10	<ul style="list-style-type: none"> To record income on deposits with the bank 	17.65	
Expenses				
Purchases	70	<ul style="list-style-type: none"> To account for cost of sales properly Most client's purchases are on account To show actual purchases every cut-off date Due to expected monthly salaries expenses To reflect proper charging of expenses 	58.82	<ul style="list-style-type: none"> To facilitate group of companies' consolidation Because of relationship to cost of sales upon sales transaction To facilitate group of companies consolidation Because of cut-off period, there is unpaid portion which is already incurred To reflect estimated taxes Per BIR statutory reporting guidelines To facilitate group of companies consolidation To record utilities expense incurred but not yet paid To facilitate group of companies' consolidation To record monthly rent expense as per contract To facilitate group of companies' consolidation
Salaries and Wages	60		58.82	
Taxes and Licenses	40	<ul style="list-style-type: none"> To account for estimated taxes for the period revenues when earned 	47.06	
Utilities Expense	70	<ul style="list-style-type: none"> To take up utilities for the period incurred Due to expected monthly expense 	47.06	
Rent Expense	30	<ul style="list-style-type: none"> To take up rental of office space for the period incurred 	58.82	
Insurance	10	<ul style="list-style-type: none"> To take up the expired portion of insurance premium paid 		
Depreciation	20	<ul style="list-style-type: none"> To take up amortization of cost of properties over the useful life of the assets 		

Appendix B
Accounts in SMEs' Financial Statements under Cash Method and Reasons for Using the Method

PERSPECTIVE OF EXTERNAL AUDITORS			PERSPECTIVE OF SMEs	
Accounts	Auditors (%)	Reason for Using Cash Method	SMEs (%)	Reason for Using Cash Method
Assets				
Property, Plant & Equipment	30	<ul style="list-style-type: none"> Recorded at purchase price but subject to depreciation as amount is normally material Maintenance is an outright expense as amount is minimal Transactions are on cash basis only 	41.18	<ul style="list-style-type: none"> <i>Acquisition cost but subject to depreciation yearly</i>
Investments	10	<ul style="list-style-type: none"> Transactions are on cash basis only 	11.76	<ul style="list-style-type: none"> Can only be acquired on cash basis
Liabilities				
Loans Payable	20	<ul style="list-style-type: none"> To properly recognize proceeds of cash from loans 	11.76	<ul style="list-style-type: none"> Cash received on application of loans are recorded
Revenue				
Sales	30	<ul style="list-style-type: none"> For recording of cash sales Client sales on cash basis Sales on credit are reported only when cash is received To record cash received for services rendered regardless of when income is earned 	23.53	<ul style="list-style-type: none"> To record cash received from sales to customers Cash receipts are sales for the period
Service Income	20	<ul style="list-style-type: none"> To record cash received for services rendered regardless of when income is earned 	17.65	<ul style="list-style-type: none"> Cash received for the period are recorded as income for services rendered
Expenses				
Purchases/Inventories	30	<ul style="list-style-type: none"> To record cash payments for purchase of goods Recorded as an outright expense to minimize or avoid monitoring activities To avoid monthly amortization work since normally chargeable within the current accounting period. To record cash payment to employees to avoid too much computation 	41.18	<ul style="list-style-type: none"> They are recorded as part of cost of sales to know the net amount as income
Supplies	10	<ul style="list-style-type: none"> To avoid monthly amortization work since normally chargeable within the current accounting period. 	41.18	<ul style="list-style-type: none"> They are consumables
Salaries and Wages	20	<ul style="list-style-type: none"> To record cash payment to employees to avoid too much computation 	52.94	<ul style="list-style-type: none"> Paid when scheduled payroll is due
Taxes and Licenses			41.18	<ul style="list-style-type: none"> Paid in accordance with regulatory deadlines Cash basis
Insurance	30	<ul style="list-style-type: none"> To avoid monthly amortization work 	41.18	<ul style="list-style-type: none"> To avoid too much work in keeping track the expired and unexpired portion

Account	Auditors (%)	Reason for Using Accrual Method	SMEs (%)	Reason for Using Accrual Method
Utilities Expense	10	<ul style="list-style-type: none"> To record payments on due dates of utility bills 	41.18	<ul style="list-style-type: none"> Payment is always updated
Rent Expense	10	<ul style="list-style-type: none"> To record when rent payment is due and paid 	41.18	<ul style="list-style-type: none"> Payment done monthly
Repairs	100	<ul style="list-style-type: none"> Expense when incurred as amount is minimal 	100.00	<ul style="list-style-type: none"> Not frequently encountered and amount is small
Security Expense	10	<ul style="list-style-type: none"> To recognize actual payment 	5.88	<ul style="list-style-type: none"> Monthly paid
Depreciation Expense	100	<ul style="list-style-type: none"> Recording of purchase and cost is amortized due to materiality as to amount 	100.00	<ul style="list-style-type: none"> To amortize the cost of Property, Plant and Equipment