Cash Basis Accounting OR Accrual Basis Accounting

Cash-basis or accrual-basis accounting are the most common methods for keeping track of revenue and expenses. Yet, depending on your business model, one approach may be preferable. You will need to determine the best bookkeeping methods and ensure your business model meets government requirements. For instance, certain businesses cannot use cash-basis accounting because of the Tax Reform Act of 1986.

Choosing the right accounting method requires understanding their core differences.

Cash-Basis Accounting: This method focuses on your business's cash flow, tracking money that comes in as revenue or goes out as expenses paid.

Accrual-Basis Accounting: This approach tracks whenever an action results in earnings or accrues an expense.

The key difference between the two approaches is timing. Cash-basis accounting documents earnings when you receive them and expenses when you pay them. However, the accrual method accounts for earnings the moment they are owed to you and expenses the moment you owe them; it does not matter when your money enters or leaves your account. That is important, as receiving or sending payment is not always immediate.

Keep in mind, however, that you must decide which method you want to use and then be consistent when tracking your income and expenses.

Cash vs. accrual at a glance

Category	Cash basis	Accrual basis
When transactions are recorded	When cash is received, or money is spent	When a sale occurs, or an expense is incurred
Tax liability incurred	When the income is received	When the income is recorded
Ease of use	Very simple and straightforward	More complex and time-consuming
Required for businesses of a certain size	No	Yes

What Is Cash-Basis Accounting?

Cash-basis accounting is also known as cash receipts and disbursements or the cash method of accounting. This system focuses on cash flow, with a particular emphasis on cash on hand. For newer or very small businesses, staying profitable is of great concern. Knowing exactly how much cash is available helps determine when bills get paid or how quickly.

The Upside to the Cash Basis

Sole proprietors and small businesses: These businesses are more likely to use cash-basis accounting, as it is straightforward and easy to use. Cash basis accounting is a method where revenue is recorded when the cash is received; likewise, expenses are recorded when they are paid. Cash accounting does not acknowledge or track accounts receivable or accounts payable. For that reason, the method is best for small businesses that do not stock inventory.

Additionally, their earnings tend to be well below the $25 million per annum restriction, making this system unavailable for income tax calculations.

Additionally, small businesses that fall under the $25 million cap are allowed to treat inventory as supplies and non-incidental materials.

Cash-only businesses: Although not as common today, some businesses do not accept debit or credit cards. These companies likely do not have to concern themselves with credit-related liabilities.

Using the cash method for income taxes is popular with businesses for two main reasons. First, the method of accounting easily allows businesses to answer questions regarding annual revenue, expenses, and financial losses. And for businesses that focus on inward cash flow, it is easier to align earnings with important dates. Income isn't taxed until it's actually in your account making it easier to pay taxes on time.

The Downside to the Cash Basis.

Though the cash-basis accounting technique has advantages, there are notable setbacks.

Because it monitors cash flow rather than accruals, it does not always paint the most accurate picture of when a company earns income or pays its expenses. Without a record of accounts receivable or accounts payable, it may be harder to correctly grasp a business's current financial health, potentially causing major discrepancies.

May lack accuracy surrounding assets or liabilities. Strictly cash-basis accounting may leave out crucial information regarding the business's unpaid invoices and its liabilities; this may also inadvertently cause the omission of certain assets.

It's not appropriate for all businesses. The IRS does not allow companies that make sales on credit or have collected $26 million in gross sales in any one of the past three years to use cash accounting.

It's difficult to transition to accrual accounting. If you start out using cash accounting, it can be difficult to transition to accrual accounting later, which can lead to mismanagement of company finances.

Cash accounting works well for many small businesses; however, if there is a concern over the health of the business and crucial details apart from cash flow, you should opt for a different accounting method.

What Is Accrual-Basis Accounting?

Accrual-focused accounting tracks revenue as it is earned and expenses the moment they are incurred. This system makes use of accounts payable and accounts receivable to formulate an accurate, real-time picture of the financial status of your business.

Accrual basis is the more common method of accounting, and it's mandatory for corporations that have gross receipts of $26 million or more in any of the past three years. Accrual accounting is also required for businesses that average more than $25 million in gross receipts over the last three years.

Accounts payable: Money your business owes to vendors or creditors.

Accounts receivable: Money owed to your business for services rendered.

Businesses using the accrual method to keep an accurate picture of accounts payable and accounts receivable will maintain their ledgers according to the current status of a bill or invoice. If you, for example, have a long-term relationship with a particular client, there would be documentation that shows when the service was rendered, the date an invoice was generated and when the invoice was paid. The same may be true for ongoing relationships with vendors with whom you do business.

These documents reveal when you receive payments and any invoices that are still outstanding. Likewise, you can show which bills your business has already paid and any expenses or liabilities that have yet to be dealt with. This method makes it easy to keep the unique situation of each sale or bill up to date, adjusting when each item is satisfied or keeping notes of anything still outstanding.

Therefore, the accrual-basis accounting method ultimately provides a greater overview of your business's financial situation, taking far more into account than cash flow or cash on hand.

The Upside to the Accrual-Basis Accounting

Accrual accounting is often a must for larger businesses, as they tend to have far too many moving financial parts to rely on the far more simplistic cash basis approach. A few instances of when the accrual method works best:

When accepting or making credit card payments: While cash payments can be accounted for fairly quickly, it takes time for credit-based statements to arrive. Additionally, such payments can post days or weeks after the transaction initially occurs.

Tracking assets and liabilities: In addition to cash on hand, businesses also count checks, short-term investments and inventory as assets. Likewise, any unpaid expense is a liability, acknowledged before bills get paid rather than after payments are sent. Accrual accounting makes it easier to distinguish assets and liabilities by keeping up-to-date records of what items fall into either category and for how long.

Ensuring GAAP compliance: Public companies within the U.S. must adhere to the Generally Accepted Accounting Principles, or GAAP, as decided by the Financial Accounting Standards Board (FASB). Therefore, such businesses are required to use accrual-basis accounting, as it meets GAAP standards.

It allows tax savings for depreciation. While businesses that use accrual accounting incur tax liability for sales earlier, they may also be able to take advantage of depreciation (of certain assets) to save money on taxes over the long term.

Additionally, accrual-basis accounting offers a complete and accurate picture that cannot be manipulated. When evaluating a company based on exactly when cash is on hand or paid out, it is easier to misconstrue the financial state of a business. The accrual basis approach forces everything to be accounted for in a timely manner.

The Downside to the Accrual- Basis Accounting

Despite being a highly trusted and preferred form of accounting, an accrual bookkeeping setup comes with disadvantages:

It has extensive rules and regulations. Accrual accounting is more involved than cash accounting, and there are rules around specific types of transactions. There are even rules on what types of businesses must use accrual accounting.

It is very complex. Accrual-basis accounting requires far more detailed record-keeping. Even with the right software, company owners not well-versed in this type of accounting may initially find it very difficult to use.

It can consume a lot of time and money. Maintaining a series of documents year over year and constantly back-checking for changes and updates takes a lot of time. As the business grows, it will probably need to outsource maintaining business records or upgrading software tools.

It doesn’t reflect money that’s actually available. Accrual accounting shows account balances based on transactions that may not have been settled yet, so you may not have as much cash as your records show you having.

It may require you to pay taxes on income you haven't yet received. Sales you make at the end of the year will be taxed in the year the sale was made, even if the cash for the sale isn't received for weeks or months.

Ultimately, this method may become more expensive or time-consuming, making it harder for small businesses to use.

The major differences between cash and accrual accounting come down to three factors: timing, complexity, and responsibility. The cash basis approach is easy to use, but it often fails to provide a complete picture of a business's finances. Meanwhile, the accrual method requires a more thorough approach that makes it easy to form a complete financial picture of your company and its current health.

Simplicity can work for individuals or very small businesses, but not as much as a company expands. Therefore, it might make sense for a small business to start with the cash basis approach and switch when the company requires greater accountability.

Cash vs. Accrual Accounting: The Bottom Line

Example of how cash and accrual affect the bottom line.

Take, for example, a small retail business that completes the following transactions in one month:

Purchases inventory for $5,000

Pays $300 in utilities.

Receives a $500 bill for building maintenance.

Makes $8,000 in sales.

Sends a $2,000 invoice for a custom order fulfilled.

Under the cash basis method of accounting, the business has $2,700 in profit for the month. This is because the $500 maintenance expense and $2,000 invoice are not included in the month's accounting because the funds have not been spent or received. On the other hand, if the business uses accrual accounting, its books will reflect a profit of $4,200 for the month by including all the income and expenses recorded during that time.

Accrual-basis and cash-basis accounting each have their advantages and drawbacks. There are logical reasons, such as company size and budget, that might lead a business to prefer one system over the other.

Small businesses that are expected to grow may also want to start with accrual basis accounting, so they're prepared for future accounting needs.

Depending on what type of business you are, how much money you make, and the types of sales you make, you may not have a choice. The IRS requires certain businesses to use accrual basis accounting.

For example, corporations other than S-corps must use accrual basis accounting if they averaged over $25 million in gross receipts over the past three years. Certain corporations and tax shelters – including those that make sales on credit – are also prohibited from using cash accounting.

If you are unsure which approach is best for your business, it may be a good idea to seek professional advice to determine if your company should use cash or accrual accounting. Also note, businesses that start off using one accounting method and decide to change later can do so by filing IRS Form 3115 and getting approval from the IRS to change their accounting method (if they qualify).