Cash Accounting vs Accrual Accounting

Cash and accrual accounting are two distinct methods used for recording and reporting financial transactions. The difference is primarily when and how transactions are recorded in the company's financial records. It's important to understand the difference between cash and accrual accounting so business owners can use financial reports to make informed decisions.

Cash Accounting

Cash accounting is the simplest accounting method because it's the easiest to understand and use. This accounting method records transactions only when there is a change in cash. So, sales/revenue/income are recorded when payment is received and expenditures/purchases are recorded when paid. It's important to note that this method *does not* utilize accounts receivable, accounts payable, inventory, capital assets, depreciation, and other long-term assets or liabilities.

Example 1: A customer was invoiced $5,000 for merchandise shipped on February 1st. The company receives the $5,000 payment for the merchandise on March 1st. Although the order was shipped a month before, under the cash accounting method, the sale would be recorded on March 1st when the payment was received.

Example 2: An online store purchased $10,000 of product from a vendor on credit in June, with payment due in July. Under the cash accounting method, the business would record the purchase of the product as an expense when payment is made to the vendor in July.

Accrual Accounting

The accrual accounting method records revenues as they are earned (not when payment is received) and expenses when they are incurred (not when payment is made). The goal of accrual accounting is to better align revenue and expenses, and which ultimately provides a better financial depiction of a business's profitability. It's important to note that this method *does* utilize accounts receivable, accounts payable, inventory, capital assets, depreciation, and other long-term assets or liabilities.

Example 1: A customer was shipped $5,000 of merchandise on credit on February 1st. The company receives the $5,000 payment for the merchandise on March 1st. Although the payment was received a month after the merchandise was received, under the accrual accounting method, the sale would be recorded on February 1st when the merchandise was shipped to the customer. An accounts receivable would be created for $5,000 on February 1st and would be removed from accounts receivable when the payment is received on March 1st. The product cost for the product that was sold would be removed from inventory and recorded as cost of goods sold in February – aligning the timing of when the sale of the product is recorded and when the cost of the product is recorded.

Example 2: An online store purchased $10,000 of product from a vendor on credit in June. Under the accrual accounting method, the business would record the purchase of the product as inventory (asset) and record accounts payable (liability) for $10,000 in June, and would be removed from accounts payable when the payment is made to the vendor in July.

Should a small business use the cash or accrual accounting method?

Many small business owners choose the cash method of accounting because it's a simplified bookkeeping process that is similar to how you might track their personal finances. For small companies that conduct business primarily through cash transactions (do not sell or buy using deferred payment terms) and/or do not maintain inventories of product, the cash accounting method can be a convenient and easy way to track revenue and expenses without the need for a great deal of bookkeeping. It's easy to track money as it moves in and out a business's bank account because there's no need to record receivables, inventory, or payables.

The Generally Accepted Accounting Principles, or GAAP, are the standard framework of rules and guidelines that accountants must adhere to when preparing a business's financial statements in the United States. Under these guidelines, all companies with sales of over $25 million must use the accrual method when bookkeeping and reporting their financial performance. That said, the accrual method is preferable for small businesses that sell a product using deferred payment terms and/or consistently maintain a level of inventory.

While accrual accounting has its advantages, there are some drawbacks. Among the most commonly cited is that it's a more complex method of bookkeeping and its inaccurate portrayal of a company's short-term financial (cash) position. In addition, since a company records financial transactions before cash is received or paid out, cash flow has to be tracked separately under the accrual method to ensure a business is appropriately tracking their cash balance.

Can a business switch from cash to accrual?

The reason some small business owners find the need to switch from cash to accrual is because of the benefits and accuracy the method provides. It gives you an exact layout and understanding of your company based on the transactions which are recorded immediately, even if there isn't a settlement in cash. Having this understanding helps you assess your company's performance and finances, and prepare for the future.

You can switch from the cash to accrual method of account, but when it comes to making the actual switch, you will need permission from the IRS. After making the proper adjustments to your financial records, you will need to fill out IRS Form 3115. This document allows you to request a change in your overall method of accounting or accounting treatment of any item. You must attach your profit and loss statement and balance sheets from the year before. When you are filing for the automatic change option, you must fill out all three parts of the form.

What are some of the income tax considerations?

A small business may benefit using one method over the other when it comes to income tax filings. If your business uses the accrual method, for example, you might claim deductions for business expenses in a given tax year even if the business paid for the product or service the following tax year.

When it comes to income taxes, cash basis accounting has definite perks. With this method, you don't have to pay taxes on any money that has not yet been received. For instance, if you invoice a client or customer for $1,000 in October and the business does not receive the payment until January of the following year, the business would include the income from that sale on the following year's income tax return. Keep in mind that the IRS requires companies to use and maintain the same accounting method to report taxable income for a year — so no changing halfway through the tax year.