

## **Accrual Versus Cash Basis Accounting**

Among the choices new businesses have to make is one about which accounting method to use. Like many of the choices a new business makes this decision will affect the way you work for the life of your business because whatever method you choose in your first year of business is reported to the IRS and can not be changed without permission from the IRS in advance or you will be subject to penalties.

Learning the difference between the Cash and Accrual methods will help you make an informed decision as to how to set-up your company's bookkeeping and accounting system. New business owners often ask which is best and the answer is they both have advantages and disadvantages with the Cash Basis Method being most common.

Cash vs. Accrual is all about timing, as in when transactions are counted. In the Cash method, transactions, including both purchases and sales (debits and credits) are counted as paid when they are "Actually" paid. In the Accrual method they are counted as paid when an order is placed or received regardless of when the money actually changes hands.

To help you better understand the differences following are a couple of examples.

### **Cash Basis Method - Purchase**

Your business buys a new computer in February and you pay for it in May, 3 months later. Using the Cash method, you would record paying \$1,000 for the computer in May.

### **Accrual Basis Method - Purchase**

Your business has new a multi-function printer delivered to your office May and the invoice for \$1,000 is not due until July. Under the Accrual method you would record the payment in May since that is when you received the printer and became obligated to pay for it.

### **Cash Basis Method - Sale**

Your carpet store installs a new commercial carpet in the office of ABC Plumbing in August and does not get paid until October. With the Cash method you would record the payment in October, when you received the check.

### **Accrual Basis Method – Sale**

Using the Accrual method you install a carpet to Acme Electric in November and are not paid until January you would record the income in your books in November, even though you did not receive the payment until the following calendar year.

An advantage of the accrual method is that it paints a more accurate picture of give and takes of your business income and debt it does a poor job of letting you know what your cash reserves are, which can be a serious problem, for example; your ledger can indicate

that you have \$5,000 in sales and your bank account shows a balance of \$0.00 because you have not received payment for the sales as yet.

On the plus side, the Cash method provides a much more accurate representation of your actual cash on hand it may not be as precise in describing your longer term profitability. With the Cash method your records for May might be wildly profitable because you have a lot of cash when the reality is that your sales have been less than expected but a large number of customers paid bills due from previous months.

The most important way your business is affected by the accounting method you choose is tax year in which your income and expenses are counted. There are important differences between the methods and following are two examples to explain.

Using the Cash method you purchase a new truck for your business in November 2012 and pay for it in January 2013 you won't be able to take the expense as part of your 2012 return.

Using the Accrual method for the same transaction you would be able to deduct the expense for the new truck in 2012 even though you did not pay for it until 2013.

Thus far we only discussed using either Cash or Accrual, however there is a third option which is the hybrid approach or a combination of the two methods. Some small businesses like aspects of both the Accrual and Cash basis and the IRS allows this if the combination clearly shows your income and expenses and is used consistently. The IRS does have restrictions on this and they are:

- If your business requires an inventory to account for your income you must use the Accrual method for purchases and sales, generally speaking. You may use the Cash method for all other income and expenses.
- If you choose to use the Cash method for recording income you must use the Cash method for recording your expenses.
- If you use the Accrual method for recording expenses you must use it record income.
- In cases where you use a combination of methods that includes the Cash method, you must treat the combination as the Cash Method.

Once your accounting method is established you must, as a rule, stick to it. The IRS does give approval to change methods but an Application for Change in Accounting Method must be filed with the IRS and there may be a fee involved.