Cash vs Accrual Accounting for Small Businesses

In the debate of cash vs accrual accounting, learn which method of accounting is the best for your small business.

Every small business must make a choice between two accounting methods--the cash method or the accrual method. The difference between the two is how and when you record income and expenses. In the cash vs accrual accounting debate, most experts recommend the accrual method for businesses, however, there are pros and cons to both and ultimately it's up to you to decide which is right for your business.

Cash vs Accrual Accounting: The Cash Method

With the cash method, you record income when you actually receive payment from customers and have the cash in hand. Similarly, you record expenses when you actually write a check and the cash leaves your bank account. If this sounds familiar, it's how people balance their checkbooks and manage their personal finances. It's a simple accounting method that makes intuitive sense.

For example, if you sell $500 of merchandise to a customer on January 1 and receive payment on March 1, using the cash method, you could record it as income on March 1.

However, using the cash method has a tendency to distort the picture of your income and expenses because it doesn't account well for situations where you've extended credit to customers or used credit to buy from suppliers. The cash method can also lead you to believe the business is experiencing false highs and lows. For example, if you receive many payments one month, you may believe your business is booming, when in actuality, the sales took place many months earlier and business is actually slowing.

Cash vs Accrual Accounting: The Accrual Method

With the accrual method, income and expenses are recorded when they are obligated to be paid. In other words, if you make a sale, you record it as income on the date of the sale, not when you actually pay for it. And you record an expense the day you incur the expense, even if you don't actually pay for it until a later date. Most experts agree that the accrual method gives you a better picture of your financial outlook because it accounts for money that flows in and out of your business. By calculating accounts receivable and accounts payable, you'll have a clearer picture of profits for any given period.

In the above example, using the accrual method you would record the $500 as income on January 1, the day you sold the merchandise, rather than March 1, when you actually received the customer's payment.

On the other hand, by recording accounts payable and receivable, you may lose track of how much cash you actually have on hand. There's also an extra step of determining the transaction date of the service or purchase. You use the date of completion as the transaction date. So if you require electrical work to be done for your business, you record it as an expense on the date the job is completed, not the date you hired the electrician.

Cash vs Accrual Accounting: Which is Best for Your Business

The cash method is undoubtedly the easier method to maintain because you only record when you receive cash or pay cash out. It's intuitive, familiar, and straightforward. Using the accrual method, you will generally have to do more recording and financial housekeeping, although with accounting software such as Quicken, the program does much of the work for you.

If your small business has sales of under $5 million per year, you're free to use either the cash method or accrual method. However, if your business keeps an inventory of merchandise to sell to customers, you are required by the Internal Revenue Service to use the accrual method for the inventory (that is, for the sales of merchandise to customers and purchase of more inventory).

While the cash method gives you a better picture of what's in your bank account, its ability to give you a clear picture of how your business is doing (how many sales you've completed, how much money is expected, and how many expenses you need to pay) is severely limited.

On the other hand, the accrual method can give you a clearer picture of the business' health but doesn't do such a great job of telling you what cash you have on hand, which could in turn lead to you adding debt you can't afford (although this is something that keeping a close eye on your bank account can go a long way toward curing). Also, for some small businesses, the accrual method is unnecessarily complicated and shifting tax burdens using the accrual method is difficult to navigate.

Some small businesses choose to utilize a hybrid method where they use accrual for their inventory, as required by the IRS, but use the cash method for other income and expenses.

Cash vs Accrual Accounting: Tax Implications

All businesses want to reduce their tax burden as much as possible. Whether you use the cash or accrual method, you should be aware of the ways to best reduce your tax liability each year. Typically, the accrual method allows the most flexibility because you can better control when you invoice customers.

For example, let's say you make a sale on December 27, 2009. If you use cash accounting, you cannot record the sale as income until the customer actually pays, which could be weeks or months later. On the other hand, if you use accrual accounting, you can invoice immediately and count the sale as income in 2009 or send the invoice on January 1, 2010 to record the sale for your 2010 income.

One strategy to lower your tax burden is to determine, as best you can, which year you believe will be your higher revenue year. Once you do that you can try to minimize your income during the higher income year, and also maximize expenses during that year. If you're using the cash method, you can try to collect payments during what you believe will be the lower income year to decrease your tax bill during the higher year. You can also pay off expenses during the higher income year to increase your deductible expenses during the year you'll likely have to pay more in taxes.

If you use accrual accounting, you can issue invoices during the lower income year to decrease the tax bill in the high income year. You can also ask suppliers, vendors, and other creditors to invoice you before or after January 1 to gain the most tax flexibility.

Of course, you'll have to pay taxes during one year or the next, but you can strategize to the best of your ability to decrease your liability as much as possible.

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