Beacon
SMALL BUSINESS SOLUTIONS

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Cash vs. Accrual Basis of Accounting

Want a fun way to start your next conversation with your Tax Preparer or Accountant?

Just ask them, casually of course, whether they filed your last return on the cash basis or on the accrual basis.

And watch them jump. You see, we're not used to clients knowing that there is a difference, much less understanding the difference.

And that difference can have a huge impact on your taxes, particularly if you operate a business.

The answer, in most cases, is that your taxes are filed on the cash basis.

So, what is the difference between cash and accrual accounting?

Cash Basis

The cash basis is the simpler, and more often used. It recognizes income and expense only when cash changes hands.

If I receive my property tax bill for 2006 in October, but don't pay it until 2007, I don't have a 2006 property tax deduction that I can itemize.

Similarly, the Property Tax folks don't have any revenue from me on the cash basis.

Accrual Basis

You can probably see where this is going. The accrual basis of accounting recognizes revenue and expense at the time the legal commitment to buy or sell was made.

In the property tax example, I do indeed have a 2006 property tax expense. The accrual basis doesn't care whether I pay my bills or not; just that I received them.

In the context of a business, the accruals basis will include as income all invoices you send out, even if you don't get paid for them.

The cash basis, on the other hand, will include only those invoices for which you receive payment.

The same logic dictates that the cash basis will also include payments received this year for invoices issued last year.

Which One Is Better for a Business?

This is a trick question. There's only one answer to a question like this: "It depends."

In most cases, small businesses will want to report their taxes on the cash basis. After all, why pay income tax when you never got paid for some of the work?

But you want to operate your business on the accruals basis. After all, you did bill for the work, and you do expect to get paid.

You've heard of keeping two sets of books for tax purposes? This is one of the ways it's done.

Manage your company on the accrual basis. You want to know everything you can know.

But report your taxes on the cash basis. Don't pay taxes on work you never got paid for.

Last month I talked about using QuickBooks©, the Accounting and Management Control System so often used in small businesses.

The main objective in using QuickBooks or any accounting software should be to generate meaningful and timely financial and management reports.

And the report of most interest is the Income Statement. It's pretty important to know whether QuickBooks is producing this Income Statement on the Cash or on the Accrual basis.

This change can make all the difference in the world. I have seen many instances where switching from one basis to the other produces a $200,000 swing in profits, and can change a profit to a loss.

Switching from one basis to the other is very, very simple in QuickBooks as well as in other accounting softwares.

First, bring up your income statement for the Date Range you want to review.

The upper left-hand corner of the report will tell you whether the report is produced on the Accrual or on the Cash basis.

To change this basis, click the Modify tab at the upper left-hand corner of the report.

You will then see radio buttons for both types, one of which is selected. Simply click on the other radio button, and click "OK".

You now have switched the basis of accounting.

If you have substantial Accounts Receivables, or substantial Accounts Payables, you will have altered your Income Statement, and ultimately your taxes, dramatically.

And you now have new insights—read control—into how your business behaves for taxes.

And you're better prepared to discuss these behaviors with your Accountant or Tax Preparer, once they have regained consciousness...

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