

Cash Basis or Accrual Basis Accounting: What's Better?

5 min read



Key Takeaways

- Cash basis accounting is the simplest form of accounting and doesn't have to adhere to Generally Accepted Accounting Principles (GAAP) guidelines. You record revenue when you receive the actual cash from customers and expenses are recorded when you actually pay vendors and employees.
- Deciding between cash basis or accrual basis accounting really depends on the state of your business. For reporting purposes, accrual basis will usually provide better financial intelligence on the true state of your business.

Deciding between cash basis accounting and accrual basis accounting can be a difficult decision when you are first starting your business. Each offers different viewpoints into your company's financial wellbeing.

Many companies can choose which method they want to use depending on the needs of their business. The real difference between the two is the timing of when your company accounts for its expenses and revenue earned. Let's discuss what each offers a business.

What is Cash Basis Method of Accounting?

Cash basis accounting is based on your company's cash activity. It tracks when cash comes in and when it goes out. You can think of cash basis accounting similarly to your checkbook register – at the end of the month, you balance everything to see how much cash you have in the bank.

Cash basis accounting is the simplest form of accounting and doesn't have to adhere to Generally Accepted Accounting Principles (GAAP) guidelines. You record revenue when you receive the actual cash from customers and expenses are recorded when you actually pay vendors and employees.

Your business might not need someone with [vast experience in accounting](#) to be in charge of your books, but cash basis won't give you complete insight on how your business is actually performing.

What is Accrual Basis Method of Accounting?

Accrual basis accounting applies the matching principle - matching revenue with expenses in the time period in which the revenue was earned and the expenses actually occurred. This is more complex than cash basis accounting but provides a significantly better view of what is going on in your company.

With accrual basis accounting, entries are made before you close out the financials for the month, this way revenue is identified in the correct period and accruals for any expenses which occurred during that period that might not have been paid yet are accounted for.

This way you can put revenue into the correct period and accrue for any expenses that occurred in that period that might not have been paid.

This method allows for a more accurate trend analysis of how your business is doing rather than fluctuations that occur with cash basis accounting.

Does Your Business Need Cash Basis or Accrual Basis Accounting for Tax Reporting Purposes?

Choosing which type of accounting for your business depends on many factors. Before filing with the IRS stating whether your company will be cash or accrual, you should understand your strategic plans in order to make an informed decision.

Cash basis is ideal for startups because the accounting is easier and management can focus their time on strategic planning.

However, startups or small businesses should ask themselves some basic questions before choosing between cash and accrual.

- Will the books be audited?
- Will you be selling the company in the near future?
- Do you need to obtain bank financing?
- Will the company go public?

If any of these questions are yes, accrual basis accounting might be best for your company. Investors and external parties need more complex reporting that shows how the business is performing.

Since the IRS requires most nonprofit organizations to file a 990 information return, accrual basis accounting is preferable because it allows for GAAP compliance. However, [most nonprofits struggle with monitoring their cash](#), so they might look at cash basis reports or cash projections on a monthly basis.

Medium to large businesses, whose sales exceed 5 million on average over a three-year period, are required to do accrual basis accounting.

Making the Decision about Cash Basis vs Accrual Basis Accounting for Your Business

Deciding between cash and accrual really depends on the business. We have clients who use cash or accrual and some who use both.

Examples:

One of our clients was using cash basis accounting and started to experience rapid growth. Cash basis wasn't giving them a clear picture of the overall performance of the company and cash flow was a big issue for them.

We converted their books to accrual-based accounting so they could pull key performance indicators (KPIs) and see a general trend of their financial standing. Cash was short so we created a days [sales outstanding \(DSO\) KPI](#) to help them with cash projections because even with rapid growth, there was little money in the bank. This allowed them to see where problems existed and how much money they had in the bank at any point in time.

Another client stayed on a cash basis because they have seasonal activity. They didn't want to make the accounting harder for the periods when they aren't making as much money. As a smaller, seasonal business, with peaks and valleys, cash basis accounting works well for them.

Reporting with Cash Basis Accounting and Accrual Basis Accounting

Cash basis and accrual basis are only a piece of the picture and it's really important to look at both to understand what is actually going on with your company.

Accrual gives a better view of your profitability. You can see a trend analysis because you recognize revenue and expenditures in the period in which the revenue was earned and the expenses occurred.

You can see a forecast of your monthly burn rate for operating expenses and get an idea of what you need your gross profit to be in order to cover these expenses.

Cash basis accounting can show larger fluctuations because one month might be really profitable and the next is not because of the timing of receipts and money going out. That doesn't usually reflect the true profits on a job or project. If you want to see how well your overall operations are, accrual basis will give you a better view.

Summary

Deciding between cash basis or accrual basis accounting really depends on the state of your business. For reporting purposes, accrual basis will usually provide better financial intelligence on the true state of your business.

GrowthForce provides detailed reporting for your business backed by bookkeeping and accounting you can trust. We have clients who use both cash basis and accrual basis accounting and can provide reports needed to drive profitability for your company.

We provide critical oversight and account management to ensure that the right policies, procedures and systems are implemented and accurate financial and management reports are produced. We help businesses run with total confidence backed by financial and management reporting they can depend on.