CASH OR ACCRUAL? CHOOSING YOUR ACCOUNTING METHOD

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Per IRS rules, the cash basis is generally only available to businesses with less than $25 million in annual sales.

Cash or Accrual? Choosing Your Accounting Method.

If you're starting a small business, choosing which accounting method to use is a major decision.
The two main methods of recording transactions – cash basis and accrual basis – can have different impacts on your bookkeeping process, your tax strategy, and even your ability to secure financing and investments. Each of these accounting methods have pros and cons, depending on your business needs and goals. Here's what you need to know:

Timing Is Everything
The essential difference between cash basis and accrual basis accounting is the point at which income and expenses are recorded.

With cash-basis accounting, income is recorded when it's *received*, and expenses are recorded when they are *paid*.

Example: On September 2, you invoice a customer for $5,000 of merchandise and get a utility bill in the mail for $500. Your customer pays you on September 14 and you mail a check to the utility company on September 29. These transactions would be recorded on September 14 and September 29, respectively.

With accrual accounting, income is recorded when it is *billed*, and expenses are recorded when they are *incurred*. So, in the above scenario, you would record both transactions on September 2 – the date that you invoice the customer and receive the utility bill regardless of when the money is received or paid.

Cash: Keep It Simple
The main advantage of the cash basis is its simplicity.

The figures on your balance sheet stay consistent with your bank balance, so it's easy to track your cash flow, and no complex accounting is needed. That's why the cash method is widely used by smaller businesses and sole proprietors. Not surprisingly, it's also the method that most individuals and families use to stick to a budget.

Another upside of cash accounting is the ability to defer income into a new tax year while accelerating deductible expenses – which can help some businesses save money at tax time. For sole proprietors, it could even be vital to keeping your business afloat.

Accrual: See the Bigger Picture
However, the cash basis method can fail to accurately capture your business's performance. Because it's natural for income and expenses to fluctuate throughout the year, cash accounting can appear to under- or overstate your profitability at any given time. This is especially true for construction companies, consultancies, and other small businesses that may not see regular daily income as a restaurant or retailer would. By taking into account factors like long-range projects and prepaid expenses, accrual accounting presents a smoother, clearer picture of your enterprise's ability to generate value.

The IRS requires most corporations (other than S corps) to use the accrual method if they average more than $25 million in sales over a three-year period; the IRS states that if an inventory is necessary to account for your income, you must use an accrual method to account for purchases and sales. Additionally, many investors and lenders will want to see your financial documents prepared on an accrual basis.

One downside of accrual accounting is that it doesn't give any indication of your current cash position, so it's vital that you carefully monitor your cash flow with separate metrics.

The Best of Both Worlds?
Software that records transactions using both methods will allow you to see the big picture that the accrual method offers, as well as the day-to-day granular data provided by cash accounting.

Know the 12-Month Rule
If you're using cash accounting, it can be beneficial to prepay certain expenses before the end of a tax year in order to take advantage of deductions. But it's essential to remember the 12-month rule: you can only deduct prepaid expenses as long as the right or benefit doesn't extend past a 12-month period *or* beyond the end of the following tax year.

For example, let's say you pay for membership in a professional association on December 31, 2022, and the membership is valid for calendar year 2023. Both parts of the 12-month rule are satisfied, so you can deduct that expense in tax year 2022.

If you're using accrual accounting, there are more stringent rules for deducting prepaid expenses. Consult a tax professional.

Optimizing Your Finances
Your choice between cash and accrual accounting will depend on a number of factors, including your business size, industry, transaction volume, and any applicable IRS rules. If in doubt, an accountant or tax professional can help you make the decision that's right for you.

Whichever accounting method you choose, having the right banking partner is key. Partnering with a trusted financial institution can help your small business access the cash management tools it needs to streamline receivables and better control payables.

A Smart Choice
When it comes to moving your business forward, contact your financial institution for guidance.