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# What Is Cash Basis Accounting?

## Learning about cash basis accounting, one of the most common business accounting methods around, can help your company's cash flow.

*By Mark Henricks*
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The two most common methods of business accounting are cash basis accounting and accrual accounting.

While each has different characteristics and advantages, the basic difference between them comes down to timing.

Cash Basis Accounting: Examples

"Cash basis accounting captures transactions when there is cash involved," explains Lisa Koonce, an accounting professor at the University of Texas at Austin. "For example, when buying office supplies, the company typically pays cash for them. Under cash basis accounting, the company then has a business expense and a reduction in their cash balance."

For an example of how cash basis accounting would work with revenues, consider a small business that sells to other businesses. Its customers pay its invoices in 30 days. The business would record revenues from sales when the payment actually arrives, 30 days or so *after* the invoice is sent.

With expenses such as payroll, a similar small business would record the expense of paying workers on payday. In other words, cash basis accounting calls for recording payments to workers when paychecks are actually distributed, rather than when the workers earned the pay.

Cash basis accounting adequately reflects many small firms' financial situations, says James Cassel, chairman and co-founder of Miami investment banking firm Cassel Salpeter. Restaurants, for instance, are often well-suited to cash accounting because there's little difference in the timing of when they receive money and pay bills.

"With most restaurants if they're paying bills on time, everything is within 30 days. They're getting paid when the customer comes in with cash or a credit card, then receiving the credit card payments in a couple of days," Cassel says. "It doesn't make a lot of difference in how they manage the business whether they use cash or accrual."

## Accrual Basis Accounting: Examples

"In contrast, accrual basis accounting captures transactions when an economic event occurs, which may or may not involve cash," Koonce elaborates. "So, for example, when a company uses electricity, they would under accrual accounting recognize electricity expense at that time. They would do so even if the payment for that month's electricity bill occurs later on, like the next month once the bill arrives."

Payroll provides another important example of how accrual basis accounting treats expenses. A business using accrual basis accounting would record the costs of paying its workers as they do the work, rather than when the paychecks are distributed.

Revenue works similarly. A business using accrual basis accounting records income when the company has earned the revenue. So a consultant would record revenue as billable hours are completed. A building contractor would record revenue when a remodeling job is finished. A manufacturer would record revenue when product has shipped.

In these cases, actual payment may not arrive for weeks or even months, but the revenue is recorded when it is earned.

## Which to Use? Cash vs. Accrual Basis Accounting

Since cash basis accounting is focused on cash transactions, it highlights other differences between the two accounting methods. For instance, cash accounting doesn't recognize accounts payable or accounts receivable, which are important parts of accrual accounting.

The cash accounting method is more popular among smaller businesses. Sole proprietors, especially those who don't have inventory, are particularly likely to use cash basis accounting rather than accrual accounting.

"Cash basis accounting is much simpler than accrual basis accounting, so for small businesses it is a more cost effective way in which to keep track of transactions affecting the company," Koonce says.

Although it's simpler, cash basis accounting does have some limitations.

"The biggest disadvantage of cash basis accounting is that it doesn't capture economic transactions in the right time period," Koonce notes. (For instance, a business incurs expense for electricity when the business uses the electricity, not when it pays the bill the following month.)

Looking at cash flow seems more straightforward and less complicated for a business that uses cash basis accounting, Cassel notes.

"If you have more money in the bank at the end of the month than in the beginning of the month, and you have paid all your bills, it's a good month," he observes.

But accrual basis accounting can give a more accurate financial picture of business' financial status, especially if there's a time gap between having to make and receive payments. Accrual accounting is often more useful for long-term planning, Cassel says. This is part of the reason why larger companies are more likely to use accrual accounting.

Another key reason for using accrual accounting is when it is required by a third party. If a business is looking for a bank loan or preparing for sale, the lender or buyer might require accrual based accounting, Cassel says. In addition, public companies always use accrual based accounting.

Lenders, investors and private equity buyers often want a business to have audited books, he explains. And an audit performed under Generally Accepted Accounting Principles (GAAP) requires accrual accounting.

The Internal Revenue Service also has rules about using cash basis accounting. The IRS will accept either approach, including a hybrid of the two, with some exceptions. One is if a company that is not an S corporation has more than $25 million in annual sales. In that case, the IRS requires accrual accounting.

If accrual accounting is not required by some third party, companies are free to use either method. Some use a combination of the two, employing accrual method for sales and purchases of inventory and cash for other income and expenses. Companies may also use one method for managing the business and the other when it comes to filing taxes, Koonce says.

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Companies can switch from cash basis accounting to accrual accounting for tax purposes by filing Form 3115 with the IRS. Switching often occurs as a company gets larger and long-range cash flow planning and dealing with investors and lenders becomes important, Cassel says.

But switching accounting methods isn't common, and it usually means going from cash to accrual.

"From the IRS standpoint you can pick a method, but once you pick it you have to stick with it. You really can't go back and forth," Cassel says. "And generally, you see people change from cash to accrual. It's rare you see someone go from accrual to cash."