Foresight Accounting News

What Foresight Accounting Has Been Working On, Doing and Learning This Month April 2014

Cash vs Accrual Method of Accounting

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I know accounting methods sound like a boring topic, especially if you are not an accountant. What if a little known method to saving you tax money has been sitting in front of your nose the whole time… something that can mean a difference of thousands of dollars in tax?

The fact is accounting methods matter and choosing the wrong one can cost you a pretty penny. Let's learn a little about accounting methods, and see how your business may be able to save.

Generally, there are two methods of accounting used by small businesses – cash and accrual. The basic difference between the two methods is the timing of how income and expenses are recorded. You choose your method of accounting when you file your first business tax return.

If you ever wish to change accounting methods, you'll need to file for IRS approval, which can be a time-consuming process as well as additional money to pay your accounting firm to prepare the request. What if I told you that changing accounting methods is often worth the hassle, time and money?

While no single accounting method is required of all taxpayers, the IRS says you must use a system that clearly shows your income and expenses, and maintain records that will enable you to file a correct return. If you do not consistently use an accounting method that clearly shows your income, your income will be figured under the method that, in the opinion of the IRS, clearly shows your income.

Most small businesses use the cash basis method of accounting, which is based on real time cash flow. Under the cash method, income is recorded when it is when it is received and expenses are reported when they are paid.

For example, if you receive payment from a customer, it becomes a cash receipt and is recorded as income on the date you receive it, regardless of when contract was signed.

Likewise, when you pay a bill, the expense is recorded on the date you pay it (check or credit card payment), not the date you actually received the bill. Therefore, you only owe tax on money you have, not on money you have not collected yet (receivables).

Under the accrual method of accounting you record income when it is earned (date of contract), not necessarily when it is received. Likewise, you record your expenses, when the obligation arises, (date of vendor invoice) not necessarily when you pay the bills. In short, the accrual method matches income and expenses when they occur whether or not any cash changes hands.

For example, suppose you have a family come in and signs a contract on December 29th, but you haven't been paid by them yet. You would still recognize all expenses you incurred in relation to that contract regardless of whether you've been paid yet or not. Both the income and the expenses are recorded for that year, even if payment is received and bills are paid the following January.

Well, that's no good! You can owe taxes on money you haven't received yet! In most cases, cash is a better tax option for small businesses. The IRS does require C Corporations with gross annual sales exceeding $5 million to file an accrual tax return.

The accrual financial statements (QuickBooks allows you to print financials either way) is a good report for you to review internally, or with your Foresight Companies customer service representative in order to determine actual income/expenses and to determine actual profit earned for a particular period. I typically use the accrual method for review of business income, and run the cash method for preparing tax returns.