Why Accrual Accounting Is Preferable to Cash Accounting

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Los Angeles and Southern California business owners and entrepreneurs have two options when it comes to which method of business accounting they will use: cash basis accounting ("cash accounting") and accrual basis accounting ("accrual accounting"). Many owners and bookkeepers, especially in small businesses, believe that cash accounting is preferable to accrual accounting because it is generally simpler to process.

Cash basis financial statements are not compliant with generally accepted accounting principles (GAAP). Provided you do not have inventory, the Internal Revenue Service permits returns to be filed on the cash basis, subject to certain other tests. However, accrual accounting is more beneficial than cash accounting in almost every business situation. This is true regardless of the size of the business or its stage of growth.

What's the Difference?

With cash accounting, revenue is reported on the income statement when cash is actually *received* by your business, and expenses are reported when cash is actually *paid out*. With accrual accounting, revenue is reported when income is *earned* and realizable, and expenses are reported when they are *incurred*. Most businesses are paid after they actually deliver products or services, and they often pay for goods and services after receiving them. Both processes frequently cause the actual cash settlement to occur in a different period than when the obligations occurred. Accrual accounting takes this into consideration.

Why is accrual accounting more beneficial than cash accounting? For one thing, accrual accounting provides a more accurate picture of a company's financial position and performance at any given point in time. This is because it reflects all sales that have shipped and all liabilities that have not yet been paid. If you liquidated the business, you would have to account for all those items, so it makes sense to do this monthly so you get a true picture of your company's financial condition.

Also, if you carry inventory, you are required by the IRS to use accrual accounting for income tax reporting. IRS publication 583 states as follows: "*If you need inventories to show income correctly, you must generally use an accrual method of accounting for purchases and sales. Inventories include goods held for sale in the normal course of business. They also include raw materials and supplies that will physically become a part of merchandise intended for sale."*

But perhaps the biggest reason why accrual accounting is preferable to cash accounting has to do with obtaining financing and raising equity capital for your business. Financial statements must be prepared using accrual accounting in order to be considered GAAP-compliant. Virtually all lenders and investors want to see financial statements prepared in accordance with GAAP before extending financing or pledging equity capital to your business.

Additionally, if you are planning to sell your business, potential buyers will also want to see GAAP-compliant financial statements that use accrual basis accounting. Lenders, investors, buyers and vendors making trade credit decisions will also want to see current and accurate accounts receivable and accounts payable agings and a schedule of any current obligations, which can only be compiled if you are using accrual accounting.

Added Financial Certainty

If you use accrual accounting, you can be assured that all of your known income and expense items are accounted for properly on your income statement and balance sheet. And you won't have to worry about income and expenses mismatching with each other over two periods, like a month, a quarter, or over a year-end. These mismatching problems occur when using cash accounting and can throw a major wrench into efforts to obtain financing, venture capital or trade credit.

The good news is that you can maintain your books on an accrual basis and frequently still file your income tax returns on a cash basis if there is a significant tax benefit to doing so (and if you do not carry any inventory). Also, most accounting software programs today will allow you to generate cash basis financial statements from an accrual based general ledger with the simple touch of a button.

With QuickBooks, for example, you can select an accrual basis or a cash basis option when you print out your financial statements. As long as your receivables, prepaid expenses, capital expenditures, payables, and other accrued liabilities have been entered into QuickBooks when incurred, you will have GAAP-compliant financial statements (excluding footnotes) for a bank, investor or trade creditor to review, but you can still generate cash basis statements as well.

Concluding Thoughts

Many small business owners and bookkeepers think that cash accounting is preferable to accrual basis accounting. However, accrual accounting is more beneficial than cash accounting in almost every business situation, regardless of the size of the business or its stage of growth. Accrual accounting provides a more accurate picture of a company's financial position and performance at any given point in time. Virtually all lenders and investors will want to see financial statements prepared in accordance with GAAP before extending financing or pledging equity capital. Therefore, if your bookkeeper or CPA advises you to use (or continue to use) cash accounting, he or she is not looking out for your best interests — and you should strongly consider a change. An outsourced CFO services provider who is experienced in financial statement preparation can provide training and instruction to your financial and accounting staff in the nuances of accrual accounting.

About CFO Edge

CFO Edge, LLC delivers enterprise-class financial and operational performance solutions to executives throughout Southern California. Based in Los Angeles, our formerly-seated chief financial officers engage on demand as part-time CFOs, single-project CFOs, and interim CFOs to help business leaders successfully resolve pressing challenges and realize their financial and operational goals. At CFO Edge, we are passionate about helping our clients create, grow and sustain value. For more information, visit www.cfoedge.com or call 800.276.1750 Ext 101.