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Accounting Method: Cash or Accrual?

OVERVIEW

Cash and accrual are methods of accounting. Accountants often refer to the cash method of accounting as the “cash basis” of accounting. Similarly they refer to the accrual method of accounting as the “accrual basis” of accounting.

Most small businesses keep their tax and business records on the cash basis of accounting, while larger businesses are required by the IRS to keep their records on the accrual basis of accounting.

CASH METHOD OF ACCOUNTING

The cash method of accounting is used by small businesses, because it is easy to understand. When cash is received, the business reports revenue and when cash is paid, the business reports an expense. Under this method, a company’s financial activity depends on the flow of cash. However, sometimes business owners use this method to manipulate their income by paying expenses in advance or by deferring revenues. Some business owners defer receiving or depositing cash into their bank account until after year end to report income in the following year.

ACCUAL METHOD OF ACCOUNTING

The accrual method of accounting is used by larger companies, because it more accurately reflects their financial activity. Under the accrual method of accounting a company reports revenues in the period they are earned. Therefore, when a company sells a product or performs a service they report the revenue. Also, under this method a company reports expenses when the company incurs the expense.

Under this method the company’s financial statements emphasize when the company is owed money and when it owes others money. This method allows companies to more accurately understand their businesses performance between periods or years.

DIFFERENCE BETWEEN METHODS

The difference between the two methods is most pronounced when a company’s cash flow fluctuates greatly between reporting periods. For example, under the cash method of accounting, a construction company may appear to have a great year if they receive payments at the end of the year but perform the work and actually buy materials in a subsequent year. A correct application of the accrual method of accounting can smooth out a company’s earnings to more closely match when the Company earned its profits.

HOW TO ADJUST CASH BASIS FINANCIAL ACTIVITY TO ACCRUAL BASIS

When valuing companies, business appraisers often adjust companies from the cash basis to the accrual basis of accounting by considering what accounts receivable a company is owed by their clients and what bills they have outstanding. For example, by looking at a small law practice’s tax records, you are most likely seeing the cash basis of accounting at work. To obtain a more accurate value of such a practice, an appraiser would add the outstanding accounts receivable to the practice’s assets and add outstanding bills to the practice’s liabilities.



ACCOUNTING RECORDS

Often companies have accounting software systems (such as QuickBooks) that allow them to print financial records on an accrual basis or a cash basis of accounting, so it is possible for companies to pick the accounting method that benefits their goals. Therefore, when comparing financial statements between years, we make sure the information we receive is consistent.

QUESTIONS OR COMMENTS

Please call me with your questions or comments at 916.756.5622.

— Thomas Collins, CPA / ABV, CFA