What is Accrual Accounting?

Generating revenue and building a successful business takes time, dedication, and effort.

Choosing the right method of accounting for handling that revenue can make reaching your goals faster and more efficient, while giving you the financial freedom you need to meet your obligations and fund your ambitions.

For many businesses, accrual accounting fits the bill nicely.

Understanding how the accrual method works, and its differences as compared to cash accounting, can help you select the right method for your business.

Accrual Accounting vs. Cash Accounting

The choice between the accrual method of accounting and the cash method is driven by how your business operates. Both are driven by generally accepted accounting principles, but

Accrual Accounting

Accrual accounting records both revenue and expenses when they occur, and not when cash is actually sent or received.

“Accruals” is the term for the entries documenting revenues received or expenses paid, independent of cash payment (e.g., a credit card sale).

These accruals show up on the balance sheet in a variety of ways, such as goodwill, accounts payable, accounts receivable, and future tax liability/interest expenses.

In the accrual method, sales made are recorded as they happen, as are expenses (like wages, material orders, or services rendered by a contractor).

Tax liability can be a challenge with this method, as you’ll likely find yourself paying taxes on income you’ve yet to receive.

Cash Accounting

Cash accounting, on the other hand, is more appropriate for small businesses that primarily deal in cash.

The cash method is (spoiler alert) focused on cash flow. When your receive income, it’s added to the books.

Conversely, expenses are recorded at the time they’re paid.

Start-ups and small businesses (including solo entrepreneurs and businesses without a physical inventory) operating on a cash basis benefit at tax time from cash accounting, since expenses can be recorded immediately, but income not yet received at filing time won’t be recorded until the next tax year.

While neither method is necessarily superior, both have their advantages and disadvantages beyond tax liability.

Accrual basis accounting is the more common accounting method (and in fact, some businesses are required by the IRS to use this method of accounting).

Because it contextualizes transactions by occurrence, rather than the exchange of cash, it provides a more accurate picture of a company in the long-term.

It also allows you to connect related income and expenses (such as payments made to sub-contractors for their contribution to a given project).

However, accrual accounting still requires you to keep a careful eye on cash flow, since your financial statements can show you're reporting revenues by the boatload for a given accounting period while your bank accounts sit empty, waiting for that revenue to actually arrive.

Ignoring cash flow while using accrual accounting can prove fatal to the health of your business.

Accrual accounting requires more bookkeeping and work hours than the cash method (since you have to track both accruals and cash flow), and if you're a small business, might prove substantially more expensive.

Cash accounting is simple (no need to track accounts payable or accounts receivable) and provides a clear view of current assets since your bank statement is basically a balance sheet.

The drawback is that it's not very useful for long-term financial planning and doesn't provide much useful data for financial analysis.

Whichever accounting practice you choose, you'll need to record and report all your financial activity accurately to help your business grow—and avoid running afoul of the tax collector.

A comprehensive accounting software package makes this much easier. It also provides instant, connected, and transparent accessibility to all your financial data, making everything from forecasting to accounts payable to supply chain management easier, freeing your staff to dedicate their skills and energy to growing your business instead of simply maintaining it.

> *Accrual accounting records both revenue and expenses when they occur, and not when cash is actually sent or received. "Accruals" is the term for the entries documenting revenues received or expenses paid, independent of cash payment (e.g., a credit card sale).*

Example Accruals Report Vs. Cash Report

To explore the differences between an accrual and a cash transaction on your balance sheet, let's take a look at how each accounting method handles a given scenario.

First, let's get an overview of your company's financial activity for a given month:

1. You've completed a small construction project for a client. You send them an invoice for $7,500.
2. You receive a bill for $700 from a contractor, in this case a detail carpenter, for work done this month.
3. You paid $300 for a utility bill you received last month.
4. You received a $2,700 payment from another client you invoiced in the previous month.

If you're using the cash basis method of accounting, you would record a profit for the current month of **$2,400**. Your balance sheet is up-to-date, because payments are recorded when they are made or received.

$2,700 (income) – $300 (utility bill) = $2,400

If you're accounting on an accrual basis, your profit for this month is **$6,800**. You record your income as an receivable and your expenses as a payable, to be reconciled later.

$7,500 (income) – $700 (contractor wages) = $6,800

As you can see, the same activity produces very different results on the books based on the accounting method used.

The accrual method requires additional reconciliation when payment is actually made and received, but also shows a clearer picture of profitability for this specific month.

Is Accrual Accounting Right for Your Business?

Building a healthy bottom line is easier when you've got all the information you need—and the assets required to support your company's goals.

Using accruals accounting can help you take a long-term view and look beyond the current fiscal year as you develop and expand your business.

What's your goal today?

1. Use Planergy to manage purchasing and accounts payable

We've helped save billions of dollars for our clients through better spend management, process automation in purchasing and finance, and reducing financial risks. To discover how we can help grow your business:

- Read our case studies, client success stories, and testimonials.
- Visit our "Solutions" page to see the areas of your business we can help improve to see if we're a good fit for each other.
- Learn about us, and our long history of helping companies just like yours.

Book a Live Demo

2. Download our guide "Preparing Your AP Department For The Future"

Download a free copy of our guide to future proofing your accounts payable department. You'll also be subscribed to our email newsletter and notified about new articles or if have something interesting to share.

download a free copy of our guide

3. Learn best practices for purchasing, finance, and more

Browse hundreds of articles, containing an amazing number of useful tools, techniques, and best practices. Many readers tell us they would have paid consultants for the advice in these articles.

Related Posts