

Cash Basis vs. Accrual Accounting

What Business Owners Actually Need to Know

By Bob Wells, CFO & Financial Advisor | bobwellsco.com

If you've spent any time with an accountant or bookkeeper, you've probably heard the terms "cash basis" and "accrual basis" thrown around. The conversations tend to get confusing fast. But here's the truth: this isn't complicated. It's about timing. One method or the other, eventually all your money comes in and all your costs go out. The question is *when* you recognize them on your books.

This matters because it affects two critical things: (1) whether you can actually manage your business well, and (2) how much you owe the IRS. Get this wrong, and you could be flying blind on your financials or missing tax opportunities.

The Fundamental Difference: It's All About Timing

Let me put it simply.

Cash basis accounting recognizes revenue when cash hits your account and records expenses when you actually pay the bill. Simple. Literal. But often misleading.

Accrual basis accounting matches revenues and expenses to the same period when the work is actually done. You record a sale when you've completed the work or shipped the product—not when the customer pays you. You record an expense when you've incurred it—not when you've paid the invoice.

That's it. Everything else flows from that one principle.

Cash Basis: The Trap It Creates

Cash basis feels simple because it's all about actual money. You got paid? Record it. You paid a bill? Record it. Done.

But this is where it falls apart for most real businesses.

Under cash basis, a customer deposit becomes revenue the moment the money hits your account. Never mind that you haven't delivered anything yet. Never mind that you're holding their money as a liability. The deposit looks like profit on your books. This creates an illusion of profitability that vanishes

the moment you actually deliver.

Worse: if you have inventory, cash basis doesn't track it properly. You pay for raw materials, and under cash basis, that entire cost is an expense in the month you paid. But you didn't sell those goods yet. You're sitting on them. Your financial statements are now distorted—sometimes showing huge losses in months when you bought inventory, and huge profits in months when you sold it. Your numbers don't reflect reality.

And receivables? If you invoice a customer for \$50,000 of work but they haven't paid yet, cash basis doesn't show that income. Your books look terrible even though you've earned the money. You can't tell if you're actually profitable or just waiting for checks to clear.

Try running a business on those financials. You can't.

Accrual Basis: The Professional Standard

Accrual accounting is harder to manage, but it tells the truth.

Under accrual, revenue is recognized when you've satisfied your performance obligations. Here's what that actually looks like:

- You have an agreement with a customer
- Performance obligations are negotiated and clear
- The price is set
- The amount is reasonably determined (you're confident they'll pay)
- You've satisfied those obligations (work done, product shipped)

Once all five are true, revenue is revenue. The customer's payment schedule is irrelevant.

Expenses work the same way. The month you incur a cost is the month you record it. If you use inventory, you capitalize it (put it on your balance sheet as an asset), then expense it when you sell the goods. If you hire someone for \$50,000 and owe them the money, that's an expense now—not when you write the check.

This is called matching. Revenues and expenses get matched to the same period. Your financial statements show actual economic performance, not cash timing accidents.

Accrual basis is what GAAP (Generally Accepted Accounting Principles) requires. It's the language that lenders, investors, and accountants speak. If you ever want to get an SBA loan, bring in an investor, or sell your business, your financials need to be accrual-based.

Which One Should You Use?

This depends on two factors: what your business needs, and what the IRS allows.

For Managing Your Business

If you have inventory or customers who don't pay immediately, you need accrual basis. Period. You cannot manage a business effectively on cash basis if you're holding inventory or extending credit. Your financials will mislead you into thinking you're profitable when you're actually burning cash, or vice versa.

For service businesses with immediate payment, cash basis can work. If a consultant invoices and gets paid same-week, or a lawyer bills monthly and clients pay monthly, the distortion is minimal. But even then, accrual is better if you want to understand your true profitability and cash needs.

For Tax Purposes

Cash basis is almost always better for taxes because it lets you defer income recognition. You can stretch out when you record sales, which defers tax payments. This is one reason so many small businesses prefer it.

But the IRS has rules.

If your average annual revenue over the past three years exceeds \$25 million, the IRS requires you to use accrual basis. No exceptions.

If you have inventory—even a little—the IRS generally requires accrual for cost of goods sold. You can't just expense inventory when you buy it. The amount of inventory determines how strictly this is enforced.

Certain industries (farming, ranching, timber) have different rules. If you're in a specialized business, check with a tax professional.

The QuickBooks Trap

Here's where I see a lot of business owners get confused: QuickBooks lets you "switch" between cash and accrual reporting at the click of a button.

This is dangerous.

What QuickBooks does is take the same data (all your entries in your books) and reformat the reports to show either a cash or accrual view. But this isn't real accrual accounting. Real accrual accounting requires serious decisions about capitalization versus expensing. It requires tracking receivables, payables, deferred revenue, and inventory the right way. It requires thinking, not button-clicking.

If you're genuinely switching to accrual accounting for management and tax purposes, you need to rethink your chart of accounts, your recording methodology, and your controls. QuickBooks switching is a reporting trick, not a conversion.

The Bottom Line

Cash basis and accrual basis both end up in the same place eventually—all your money comes in, all your costs go out. The difference is timing.

For most businesses with inventory, receivables, or any credit extended, accrual basis is the right method for management. It shows you the truth about whether you're actually profitable. It's what lenders and buyers expect to see.

For taxes, you may prefer cash basis (and you might be allowed to use it), because it lets you manage timing and defer income. But if you have inventory or significant receivables, the IRS won't let you use it anyway.

The key: don't let your bookkeeper choose your method for you. Understand the difference, talk to your accountant about what makes sense for your business and your taxes, and set up your books the right way from day one. Changing methods later is messy and costly.

If you're not sure which method your business is using — or whether it's showing you reality — that's worth asking about.

Related Resources

Have questions? — I'm happy to discuss your specific situation.

This article is for general informational purposes and does not constitute legal, tax, or financial advice. Consult with qualified professionals before making decisions based on this content.

If you'd rather know than guess about your financials, let's have a conversation. A conversation costs nothing. Clarity might be worth everything.

bob@bobwellscfo.com | bobwellscfo.com | [linkedin.com/in/bobwellscfo](https://www.linkedin.com/in/bobwellscfo)