FINANCIAL FOUNDATIONS

An Educational Ebook Series for Small Business Owners

BOOK 12

Cash vs. Accrual Accounting

Choose the accounting method that shows the right financial picture.

TLC Business Solutions · Expert Bookkeeping & Accounting Services

SOURCE PAGE 01

Cash vs. Accrual Accounting

FINANCIAL FOUNDATIONS SERIES

CHAPTER 5

Cash vs. Accrual Accounting: Which One Is Right for You?

A clear, practical guide to the two accounting methods that shape how your small business records income, expenses, and financial health.

TLC BUSINESS SOLUTIONS

Trusted accounting, bookkeeping & tax guidance for small business

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FINANCIAL FOUNDATIONS · CH. 5

Cash vs. Accrual Accounting

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In this chapter, we break down the two foundational accounting methods, how each one works, and how to decide which method fits your business today — and tomorrow.

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CHAPTER 3 · SECTION 01

Introduction to Accounting Methods

> *Before a single dollar is tracked, every business has to answer one foundational question:* ***when do we record income, and when do we record expenses?*** *The answer defines your accounting method — and it shapes every financial decision that follows.*

An accounting method is the set of rules a business uses to determine **when** transactions are recognized in its books. It is not about *what* you record (every method tracks revenue and expenses), but about *timing* — the moment a sale or expense officially enters your financial story.

That timing matters more than most owners realize. The method you choose affects:

- **Taxable income** — which year revenue and expenses fall into on your tax return.
- **Profitability picture** — whether your reports reflect earned value or collected cash.
- **Lender & investor readiness** — banks and investors often expect accrual-based statements.
- **Day-to-day decisions** — pricing, hiring, and spending choices rest on what your numbers say.

The two methods in widespread use are **cash basis** and **accrual basis** accounting. They are not rivals so much as tools built for different stages and shapes of business. The goal of this chapter is not to crown a winner, but to help you understand each method honestly — its strengths, its blind spots, and where it fits a business like yours.

> WHY TIMING CHANGES EVERYTHING
>
> Imagine you complete a $10,000 project in December and send the invoice, but the client pays in January. Under **cash basis**, that income lands in the new year. Under **accrual basis**, it belongs to the year the work was done. Same work, same money, two different financial realities.

Throughout the rest of this chapter, we will walk through how each method works, where each one shines, and how to choose with confidence.

Cash vs. Accrual Accounting

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Cash Basis Accounting

> *Cash basis accounting is the most intuitive method: money enters your books when it hits the bank, and leaves your books when it leaves the bank.*

Definition

Under **cash basis accounting**, revenue is recorded only when cash is actually received from a customer, and expenses are recorded only when cash is actually paid out. There are no receivables, no payables, and no entries for earned-but-unbilled income or incurred-but-unpaid bills. Your books track the literal movement of cash.

How It Works

The mechanics are simple and follow the cash trail:

- **Revenue is recognized when received.** If you invoice a client in June but they pay in August, the income is recorded in August.
- **Expenses are recognized when paid.** If you receive a vendor bill in May but pay it in July, the expense lands in July.
- **No accounts receivable or accounts payable** sit on the books — transactions exist only when money moves.

CASH BASIS IN ACTION

You run a graphic design studio. You finish a logo project on March 28 and invoice $2,500 on April 2. The client pays on April 20.

Under cash basis: the $2,500 in revenue is recognized on **April 20** — the day the cash arrives. The March work does not appear in March's numbers at all.

Cash vs. Accrual Accounting

Pros & Cons

Advantages	Disadvantages
• **Simple to use.** Little bookkeeping complexity; easy to learn and maintain. • **Clear cash picture.** You always know exactly how much money you actually have. • **Tax flexibility.** Income is taxed the year it is collected, which can help with year-end timing. • **Lower cost.** Fewer entries mean lower accounting and software overhead.	• **Lacks long-term insight.** A profitable month can look empty if clients pay late. • **Can mislead.** Big unbilled projects don't appear, making performance look weaker than it is. • **Not GAAP-compliant.** Investors, lenders, and most outside parties expect accrual statements. • **Limited for inventory.** Businesses that carry inventory generally cannot use pure cash basis.

Cash basis is best understood as a **cash-flow truth-teller**: it tells you precisely what came in and what went out. Its weakness is that the truth it tells is narrow — it is silent about work done, value earned, and obligations owed.

Cash vs. Accrual Accounting

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Accrual Basis Accounting

> *Accrual basis accounting matches income to the moment it is earned and expenses to the moment they are incurred — giving you a true picture of financial performance, regardless of when cash moves.*

Definition

Under **accrual basis accounting**, revenue is recorded when it is *earned* (when goods are delivered or services are performed), and expenses are recorded when they are *incurred* (when goods or services are received), regardless of when cash actually changes hands. This method introduces accounts receivable and accounts payable into your books and aligns your financial statements with economic reality.

The Matching Principle

The heart of accrual accounting is the **matching principle**: expenses should be recognized in the same period as the revenue they help generate. If you buy inventory in March and sell it in May, the cost is recognized in May alongside the revenue — not in March when you paid for it.

This pairing produces a far more accurate profit figure. Instead of showing a giant expense in one month and a giant revenue spike in the next, accrual accounting shows the *true margin* of each sale in the period it actually occurred.

> MATCHING PRINCIPLE IN ACTION
>
> A contractor pays $4,000 for materials in February, completes the job in March, and bills the client $10,000 — receiving payment in April.
>
> Under accrual: the $10,000 revenue *and* the $4,000 expense are both recognized in **March**, when the work was performed. The $6,000 profit shows up correctly in the month it was earned — not distorted across three separate months.

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Cash vs. Accrual Accounting

Pros & Cons

Advantages	Disadvantages
• **Accurate performance picture.** Revenue and expenses align with the work that produced them. • **Growth tracking.** Trends, margins, and seasonality become visible over time. • **GAAP-compliant.** Required for publicly traded companies and expected by lenders & investors. • **Investor-ready.** External parties can evaluate your business on a consistent standard. • **Inventory-friendly.** Accurately tracks cost of goods sold and inventory value.	• **More complex.** Requires receivables, payables, accrual and deferral entries. • **Cash-flow blindness.** A profitable month on paper does not mean cash is in the bank. • **Higher cost.** Needs more bookkeeping time, better software, and often a professional. • **Tax timing.** Income may be taxed before it is collected — cash must be managed carefully.

Accrual accounting is a **performance truth-teller**: it reveals how the business is truly performing, even when cash lags behind. Its blind spot is the bank balance — which is why many accrual-based businesses still run a separate cash-flow statement alongside the income statement.

Cash vs. Accrual Accounting

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Cash vs. Accrual: Key Differences at a Glance

> *Both methods are legitimate — the differences come down to when transactions are recorded, what shows up on the books, and who the resulting reports serve.*

Comparison Point	Cash Basis	Accrual Basis
Revenue recognition	When cash is received from the customer.	When revenue is earned (goods delivered or services performed).
Expense recognition	When cash is paid out.	When expense is incurred, matched to related revenue.
Accounts receivable	Not tracked on the books.	Tracked — billed but uncollected revenue appears.
Accounts payable	Not tracked on the books.	Tracked — incurred but unpaid expenses appear.
Inventory & COGS	Generally not supported; limited inventory tracking.	Fully tracked; cost of goods sold matches each sale.
Profitability picture	Reflects cash collected vs. cash spent.	Reflects true margins of work performed in the period.
Cash-flow clarity	Strong — reports mirror the bank account.	Weak — requires a separate cash-flow statement.
GAAP compliance	Not GAAP-compliant.	GAAP-compliant; required for public companies.
Complexity & cost	Low — simple entries, minimal bookkeeping.	Higher — accruals, deferrals, professional support often needed.
Best fit	Solo service businesses, freelancers, small operations.	Growing businesses, those with inventory or credit sales.

Cash vs. Accrual Accounting

The table makes the choice sharper in the abstract, but the real decision rests on your business's **shape and stage** — which we cover next.

Cash vs. Accrual Accounting

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Which Method Should You Choose?

> *There is no universal "right" answer — only the right answer for your business's size, complexity, credit activity, and growth plans.*

Match the Method to the Business

BEST FIT · CASH BASIS

The Solo & Small Business

Freelancers, consultants, sole proprietors, and small service-based businesses with no inventory and few credit sales.

If you get paid quickly, run lean operations, and primarily need to know *how much cash you have*, cash basis is typically enough.

BEST FIT · ACCRUAL BASIS

The Growing Corporation

Businesses carrying inventory, extending credit, seeking financing, or scaling toward outside investors.

If you manage receivables and payables, need accurate margins, or plan to grow, accrual gives the clear, GAAP-aligned picture lenders and investors expect.

IRS Requirements You Need to Know

The IRS generally allows small businesses to choose their accounting method, but there are firm limits and exceptions worth knowing:

- **Gross-receipts test.** For tax years beginning after 2022, businesses with average annual gross receipts of **$29 million or less** (indexed for inflation) over the prior three years may use the cash method. Above that threshold, accrual is generally required.
- **Inventory & C-corporations.** Businesses that maintain inventory (and certain C-corporations and partnerships with C-corp partners) historically faced additional restrictions, though the gross-receipts test now exempts many smaller inventory holders.
- **Consistency requirement.** Once you choose a method, you must use it consistently from year to year. Changing methods later requires IRS approval — typically **Form 3115**, Application for Change in Accounting Method.
- **Tax-method vs. book-method.** Some businesses keep books on accrual for management but report on cash for tax — this is allowed with proper reconciliation, and a tax advisor should oversee it.

Cash vs. Accrual Accounting

A PRACTICAL DECISION RULE

If you answer "yes" to any of these, lean accrual: Do you carry inventory? Do you extend credit to customers? Are you applying for a loan or seeking investors? Do you want to track margins by project or product? Do your revenues approach the IRS threshold?

If you answer "no" to all of the above, cash basis will likely serve you well — for now.

Choosing a method is not a one-time, forever decision. It is a choice you revisit as your business changes — which brings us to the question of switching.

Cash vs. Accrual Accounting

CHAPTER 3 · SECTION 06

Switching Methods: What to Consider

> *Businesses outgrow their accounting method all the time — the question is not whether you can switch, but how to do it without distorting your financial picture or tripping on tax rules.*

Direction Matters

Switching from **cash basis to accrual** is generally the more common and more straightforward path — it reflects a business growing in complexity. Moving from **accrual back to cash** is possible but rarer, and the IRS scrutinizes it more closely since it can shift taxable income.

What to Consider Before Switching

- **IRS approval.** Most changes require **Form 3115** (Application for Change in Accounting Method), filed with your tax return. Some changes qualify for automatic consent; others need advance approval.
- **Cumulative adjustment (Section 481 adjustment).** When you switch, the difference between the two methods is captured as a one-time adjustment so that no income is double-counted or lost. This can be a tax event in itself — sometimes spread over several years.
- **Restated financial statements.** Prior-period books may need to be restated to the new basis so year-over-year comparisons remain meaningful.
- **Software & workflow.** Confirm your accounting platform (QuickBooks, Xero, etc.) is set to the new method, and that opening balances for receivables, payables, and inventory are correct.
- **Tax impact & timing.** Switching can move taxable income forward or backward by a full year. Plan the change in consultation with a tax advisor well before year-end.
- **Lender & investor communications.** If you have outstanding loans or outside investors, notify them — changing methods can shift ratios they monitor.

Work With a Professional

Because a method change touches your taxes, your books, and your reporting all at once, it is not a do-it-yourself project. A qualified accountant can run the Section 481 calculation, prepare Form 3115, restate prior periods, and make sure nothing slips between the cracks. The cost of the transition is almost always smaller than the cost of getting it wrong.

Cash vs. Accrual Accounting

THE TAKEAWAY ON SWITCHING

Switching is not a sign that you chose wrong the first time — it is a sign your business has changed. Treat the method like any other financial tool: revisit it when the business outgrows it, and bring in expert help to make the move cleanly.

Cash vs. Accrual Accounting

CHAPTER 5 · SECTION 07

Key Takeaways

If you remember nothing else from this chapter, remember these points.

The Essentials

- **Two methods, one decision.** Cash basis records income and expenses when cash moves; accrual records them when earned and incurred.
- **Cash basis = cash clarity.** It tells you exactly what you have, but is silent on earned revenue and incurred expenses.
- **Accrual basis = performance clarity.** It shows true profitability through the matching principle, but can obscure cash position.
- **Match the method to the stage.** Solo and simple service businesses often thrive on cash; growing, inventory-heavy, or investor-facing businesses typically need accrual.
- **IRS rules apply.** The cash method is allowed under the gross-receipts test (around $29M average annual receipts), but inventory, C-corp status, and consistency rules can shift the requirement.
- **Switching is possible but planned.** Most changes need IRS Form 3115 and a Section 481 adjustment — work with a professional.
- **Method is not destiny.** Revisit your choice as the business changes; the right method at year one may not be the right method at year five.

Not sure which method fits your business?

TLC Business Solutions helps small business owners choose, implement, and switch accounting methods with confidence.

tlcbusinesssolutions.com · Let's get your books on the right footing.

Disclaimer: The information provided in this ebook is for general educational purposes only and does not constitute legal, tax, or accounting advice. Specific rules, thresholds, and forms change over time — always consult a qualified accounting or tax professional about your particular situation before making decisions about your accounting method.

Build Your Financial Foundations with TLC

TLC Business Solutions helps small business owners strengthen bookkeeping, accounting, payroll, tax consulting, financial management, and practical decision-making systems so the numbers are clean, useful, and ready for growth.

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