Accounting Methods Explained

There are two types of accounting methods the IRS recognizes for most businesses - Cash and Accrual. You choose the method you are going to use when you file your first business tax return. If you later decide to change the method, you must get approval from the IRS. Therefore, it is very important you consult with an accountant well-versed in business to help you make this decision.

Cash Basis

- Income is recognized when it is received.
- Expenses are recognized when they are paid.

If you bill someone in December and receive payment for it in January, you record the income in January. If you incur an expense in December and pay it in January, you record the expense in January.

Example: If you sell someone a product and they pay you for it in 60 days, you record the income on the day you receive the payment.

Accrual Basis

- Income is recognized when it is earned.
- Expenses are recognized when they are incurred.

If you bill someone in December and receive payment for it in January, you record the income in December. If you incur an expense in December and pay it in January, you record the expense in December.

Example: If you sell someone a product and they pay you in 60 days, you still record the income on the day you made the sale.

It is very common for businesses to keep the books on an accrual basis and prepare the tax returns on a cash basis. It allows the owner to keep track of how much is owed to him (accounts receivable) and how much he owes others (accounts payable), yet still allows for filing tax returns on a cash basis.

The good news is that accounting programs such as QuickBooks will switch back and forth between cash basis and accrual basis at the touch of a button.

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