Choosing an Accounting Method

Many small business owners question which accounting method should they use in their small business. I was reminded of this last week as Bobbi Olson taught the Quick Books Basics Seminar for area small business CEOs. This question is definitely a part of “knowing your business numbers” that I have been discussing in the last few columns.

The IRS doesn't require all businesses to use a prescribed method, but it does require businesses to use a system that accurately reflects their income and expenses. The two basic ways to account for your income and expenses are the cash method and the accrual method, and some businesses use a hybrid.

The Cash Method: Using the cash method, you record income when you actually receive it and expenses when you actually pay them. For example, if you complete a project in December 2012 but don't get paid until March 2013, you record the income in March 2013. Similarly, if you buy a digital camera for your business on credit, you record the expense not when you charge the camera and take it home, but when you pay the bill. The IRS won't let you manipulate your income by, for example, not cashing a client's check until the next year; you must report income when it becomes available to you, not when you actually decide to deal with it.

The Accrual Method: Under the accrual method, you record income as you earn it, and expenses as you incur them. For example, if you complete a project in December 2012, that's when you record the income, you expect to receive from it, no matter when the client actually gets around to paying you. If the client never puts the check in the mail, you can eventually deduct the money as a bad debt. And if you charge some furniture, you record the expense on the day of purchase, not when you pay the bill.

So which method is better? It depends, of course. The cash method is much easier to use; most of us deal with our personal finances this way, so it's a system that we are familiar with. It also gives you a clear picture of your actual cash on hand at any point in time. The accrual method can't tell you how much cash you've got, but it provides a more accurate picture of your business's overall financial health, particularly if your clients or customers are pretty good about paying their bills. It will show money that you've obligated yourself to pay, so you'll know that you can't count on using that money for other purposes. It will also show money you can look forward to receiving (again, if your customers pay you as promised).
As long as you make less than $1 million a year, you may choose whichever method seems right for your business. (If you've made more than $1 million in any of the last three tax years and your business carries an inventory, you might have to use the accrual method.) For more information, check out IRS Publications 334, Tax Guide for Small Business, and 538, Accounting Periods and Methods, both available at www.irs.gov.

Here’s one last question: Which accounting system is used by most small businesses?
Answer: According to the latest NFIB Expenses Survey, 41% used the cash method, 17% used the accrual, 13 used a hybrid, and a surprising 29% did not know what system they used (apparently attributed to the fact that these owners did not have a "hands-on approach" to record keeping).

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