Cash v. Accrual Accounting – Whatchu Talkin' About Willis?

Executive summary. There are basic differences between cash and accrual accounting. Here's a quick review.

What is accounting? Sounds simple, right? It's just keeping track of money in a business. And money only does one of two things – it either goes in the bank account, or out of the bank account. However, how you show this money in your financial reports can be critical to your business's success.

Cash versus accrual. You'll want to have either "cash" or "accrual" books. This is also called "cash basis", "cash accounting", and/or "cash business". The difference lies in how a transaction is recorded in your financial statements.

Generally speaking, when working on a cash basis, income and expenses are recorded when there's an actual transaction – this means that money is either coming into, or leaving, the bank account. When working on an accrual basis, the exchange of cash is not necessary.

Example: a $50,000 expense. Let's take the annual general liability invoice from your insurance agent as an example. Say you do $4 million a year in sales in construction. It's September 1, the policy period just renewed, and you received an invoice from your agent for $50,000. Say you pay it in full today. How does this vary in your recording of the invoice received from your insurance agent?

Expense in cash versus accrual books. If you are a *cash* business, then you pay the invoice and you take the full $50,000 expense in the month of September. Why? Because you are on a cash basis, and the invoice came in in September, and you cut a check in September. You had a cash transaction, so you record the entire transaction now.

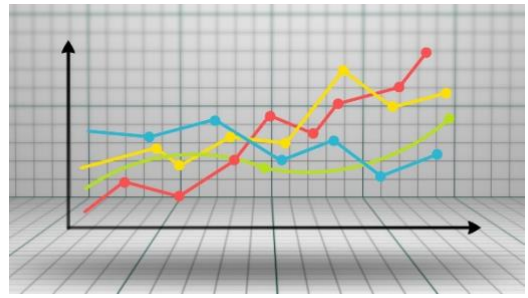
If you are on an *accrual* basis and you cut the same $50,000 check today, this expense you just paid will hit your financial reports at a rate of $4,166.67/month for each month of the year coming.

Why do I care? There's plenty of reasons you care, the two most important in my mind are (a) the manner in which you wish to display your financials to your readers and (b) for tax purposes.

Scott Jennings, P.E., is the President of [SJ Construction Consulting, LLC] (808) 271-5150, sj@sjcivil.com. He is former owner of a heavy/civil construction company and now provides cost estimating and training, litigation support, and efficiency advice to contractors. He is also the founder of [Runjob Software, Inc.] ***Download our QR scanner app: runjobsoftware.com/mobile/***

Item (b) above is for your tax accountant, but there are lots of reasons to spread out both income and expense to better control your liability to the Government. On item (a) above, for me it's about managing your business.

In construction, there is a great deal of uncertainty in financial projections. The bottom line of a job can change in an instant for a multitude of reasons. This leads to uncertainty in the profit and loss statements. And this trickles to uncertainty in your bankers and surety agents' minds in extending you credit. And as the business owner or executive, this affects your sleeping patterns at or about 1:47 am each day when you wake up in that cold sweat.



The issue is that on a cash basis, the $50,000 expense hits you all at once in September and you show a terrible month. On an accrual basis, the hit to your profit and loss statement in September is only $4,166.67. Notice that this discussion, between cash and accrual accounting, has zero do with cash flow! Your choice of cash accrual is based upon how you want your books to display for your readers.

My story. My apologies on not getting to an income example on the two accounting methods, the article was getting too long. However, the concept is the same. You can invoice your clients as much as you want, but you cannot show the revenue until it's in the bank – not when you invoice your clients.

Back to my story. If you're a new business owner then the concept of cash and accrual accounting may be foreign like Arnold Jackson in *Diff'rent Strokes* (my apologies for my 1970s childhood reference, but this show was a staple). [QR]

I have a professional services business now (the previous 26 years I was in contracting). I'm on a cash basis now. If you're a construction business, you probably are not even allowed to have cash books. You must accrue. I hate being on a cash basis. Why, because I just got an insurance invoice for $17,000 and I have to pay it now. And it does exactly what I described above – it tanks me the month I spend the money. I'd like to take the $17,000 and record it one month at a time at $1,416.67/month. Or, on the flipside, it'd be nice to actually take all my billings to my clients that went out this month and put it against this large expense. No can do.

Work safe!

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