Accrual vs Cash

One of the first steps in setting up an accurate accounting system is selecting a method of recording transactions. The two most common methods are the cash basis of accounting and the accrual basis of accounting. This article highlights the differences between these methods, and presents considerations when choosing which method is right for your organization.

Cash Method

The cash method is the simplest option, and replicates checkbook accounting used in personal finances. Income and expenses are recognized when the cash is transferred. Revenue is recorded when funds are received and expenses are recorded when bills are paid, regardless of when the transaction was entered into between the organization and the donor/customer or vendor. As a result, the balance sheet of a cash basis organization only contains cash and net assets. Receivables, prepaid expenses, payables and deferred revenue are all accrual concepts ignored when using the cash method. The benefits of this method are the simplicity and a clear sense of cash flow. The main drawback is that it is not as accurate as the accrual method for giving you the entire picture of the organization’s finances. Since revenue and related expenses are not necessarily recorded in the same period under the cash method, it does not reflect net income as accurately. The cash method is best used by very small nonprofits run by volunteers with little resources to expend on accounting and that plan to have little growth in operations over time.

Accrual Method

The more complex accrual method is what is required by Generally Accepted Accounting Principles (GAAP). If your organization plans to go through a financial statement audit or review, it is highly recommended that the organization adopt the accrual method so that it is in conformance with GAAP. Lending and funding sources also often require financial information be submitted using the accrual method. This method records income when it is earned and expenses when they are incurred. As a result, income and all of the costs incurred in the process of earning the revenue are matched and recorded in the same fiscal period, regardless of the cash ins and outs.

Nonprofit organizations also need to record contributions according to unique accrual rules that require a donation be recorded as income when the contribution is promised, not when it is received.

Accrual accounting leads to the possibility of more accounts on the balance sheet such as pledges receivable, accounts receivable, prepaid expenses, payables and accrued expenses etc. Since it is not focused on cash flow, care must be taken to reconcile cash regularly to be sure you know the organization’s cash situation. This method requires more expertise and time to execute, but if done correctly allows for better budgeting and planning.
Considerations When Choosing a Method

- Amount of payables and receivables you have on an ongoing basis – if you have few unpaid bills, outstanding grants etc., cash basis will work for your organization.

- Expertise of bookkeeping staff/volunteer – accrual accounting is more complex and time intensive. Consider the skill level of the person doing your books when deciding what method to use.

- Cash flow position – if cash flow is an issue, accrual helps you see what you have outstanding to get the full picture.

- Size of the organization – a small organization with stable operations over time can stay with cash basis. An organization that plans to grow will probably eventually need to adopt accrual accounting as more complex transactions arise.

- Audit of financial statements – if you are required or decide to undergo a financial statement audit or review, it is strongly recommended the use of the accrual method to be in compliance with GAAP.

IRS Considerations

The IRS does not require any specific method of accounting to be used in preparing the Form 990. The organizations must use the same method of accounting used in keeping its books, provided the method clearly reflects income. Therefore, cash, accrual and other methods of accounting are acceptable on the 990.

If you plan to change your accounting method, you must submit Form 3115 “Application for Change in Accounting Method” to the IRS with your annual 990, and explain the change on Schedule O of the 990. Also, you must do an adjustment which calculates the cumulative effect of the change in accounting method on income. This ensures that you do not omit or duplicate items of income or expense on the 990 due to the method change. The adjustment will be spread over income for a four year period.