Another important step in the process of keeping accurate books, is deciding whether your business will track accounting on a cash basis or an accrual basis.

What is Cash Accounting?

When using the cash basis accounting method, transactions are recorded as income **only** when you receive payments from customers; similarly, expenses are recorded only when payments are made. While cash accounting is easier, there are drawbacks; if in a given period, you collect little or no receivables and pay a large number of bills, you will have expenses without income — and you will appear to have lost money. On the other hand, if you collect payments and do not pay bills, your income will be overstated. This causes a major distortion of what actually occurred.

What is Accrual Accounting?

The accrual accounting method records income at the time of sale or completed work for a customer, whether or not you have received payment. This in turn creates an account receivable from the customer – and a current asset. Even though the cash isn't in the bank yet, sales are booked as income increasing the seller's revenue. Likewise, expenses are recorded when a purchase is made and an invoice created. This creates an account payable –and a current liability. The benefits of the accrual method is that it more accurately matches income to expenses and provides better cash control; you can easily track who owes you money and who you need to pay and when. The drawback to accrual accounting is that it requires a little additional effort. The accrual accounting belief is that it is likely, if not certain, that the company will collect the cash from sales at some point in the future because the sale had been made.

When it comes to using your financial reports to help run your business, accrual accounting gives a truer financial picture!

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