Cash-basis vs. Accrual-basis Accounting and Income Tax Returns

CASH-BASIS ACCOUNTING

Cash basis accounting is usually only followed by small businesses with no A/P or A/R open balances but is not allowed for Govt contractors. Below explains how cash-basis differs from accrual-basis accounting.

Cash-basis accounting records transactions when the cash changes hands, such as when cash is received from a customer or paid to a vendor. Cash received increases the cash and cash paid out decreases cash. Cash-basis entries are determined depending on whether the cash came in or goes out of cash accounts.

Payroll Payment	**Vendor Payment**	**Customer Receipt**
DR Increase Labor Cost	DR Increase Non-labor	DR Increase Cash Account
CR Decrease Cash Account	CR Decrease Cash Account	CR Increase Revenue Account

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ACCRUAL-BASIS ACCOUNTING

Accrual-basis accounting records costs in the month they are incurred, for example, timesheets for the period ending 3/31/15 would be recorded with date of 3/31/15 to be included in March financials. Payroll is typically run a few days later, using those same labor amounts to pay the employees and taxes.

	3/31 Timesheet Entries	**3/31 Payroll Tax Accrual**	**4/10 Payroll/Tax Payment**
1)	DR Increase Labor Expense	DR Increase PR Tax Expense	DR Decrease Payroll Payable
	CR Increase Payroll Payable	CR Increase PR Tax Payable	DR Decrease PR Tax Payable
			CR Decrease Cash Account
	3/31 Expense Reports	**3/31 AP Vendor Entries**	**4/30 AP Vendor Payment**
2)	DR Increase Non-labor Cost	DR Increase Non-labor Cost	DR Decrease Accts Payable
	CR Increase Accounts Payable	CR Increase Accounts Payable	CR Decrease Cash Account
	3/31 Revenue Entries	**4/5 AR Billing Entries**	**5/5 Customer Paid**
3)	CR Increase Revenue	DR Increase AR Billed	DR Increase Cash
	DR Increase AR Unbilled	CR Decrease AR Unbilled	CR Decrease AR Billed

Accrual-basis records cost in the month incurred to match related revenue booked in the month earned. For example, labor & non-labor cost (from timesheets & vendor invoices) for the period ending 3/31/15 to match with revenue recorded in March, which is the month it was earned in and will be billed in April.

Note the accounts in blue are accrual accounts that zero out with the posting of cash transactions to accommodate the GAAP Principle of “Matching” revenue to related labor and non-labor cost incurred. Basic GAAP (Generally Accepted Accounting Principles) compliance is prerequisite for DCAA compliance.

INCOME TAX RETURNS

Income taxes are computed separately from accounting, on cash or accrual basis, per IRS regulations or company choice if no limitations. There will almost always be differences between books and tax returns but doing both on the same basis results in fewer differences to be reconciled between books and taxes.