Cash and Accrual Basis Accounting
(Keeping Two Sets of Books Could Be a Good Thing)

A Peer-Reviewed Publication
Written by Richard C. Capasso, CPA, PFS, CFP

Abstract
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This course will give you a general understanding of both the Cash Basis Method and Accrual Basis Method of accounting, and when to use one method over another and why.

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At the conclusion of this educational activity participants will be able to:
1. Describe the Cash Basis Method of Accounting.
2. Describe the Accrual Basis Method of Accounting.
3. Identify Cash Basis and Accrual Basis financial statements.
4. Determine when to use these two different methods of accounting for practice management.

Author Profile
Richard C. Capasso, CPA, PFS, CFP is Vice-President and shareholder of Clairmont, Paciello and Co, PC, a regional certified public accounting firm, CPC Financial Planning and Tanglewood Financial Services which are based in King of Prussia, PA. Mr. Capasso is a member of numerous boards of directors, is the recipient of numerous awards and has been recognized for his contributions to the business, civic and cultural betterment of the greater Philadelphia region.

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**Abstract**
Understanding the method of accounting when looking at financial statements is important to determine the profitability of a company. There are many different methods of accounting, but the two most common are the Cash Basis Method and the Accrual Basis Method.

This course will give you a general understanding of both the Cash Basis Method and Accrual Basis Method of accounting, and when to use one method over another and why.

**Revenue and Expense Recognition**
The major difference between the Cash Basis Method and the Accrual Basis Method is when revenues and expenses are recognized.

**Cash Basis Method**
When using the Cash Basis Method, revenue is recognized when received and expenses are recognized when paid.

**Accrual Basis Method**
When using the Accrual Basis Method, revenue is recognized when earned and expenses are recognized when incurred.

Another way at looking at the difference in methods is the timing difference of revenue and expense recognition.

**Example 1:**
A dentist performs a procedure on a patient and bills the patient $250.00 on March 21, 2014. The patient receives a bill on March 27, 2014 and pays it on April 15, 2014 at her next visit.

Under the Cash Basis Method the revenue of $250.00 was recognized when it was received on April 15, 2014.

Under the Accrual Basis Method the revenue of $250.00 was recognized when the revenue was earned on the date of the procedure, March 21, 2014.

**Example 2:**
The fee for the lab work for this patient was $125.00. The lab billed the dentist on March 24, 2014 and the dental practice paid the bill on April 5, 2014.

Under the Cash Basis Method the expense of $125.00 was recorded on April 5, 2014, when it was paid.

Under the Accrual Basis Method the expense of $125.00 was recorded on March 24, 2014, when the expense was incurred.

In both examples the revenue and expenses were recognized, but the timing of the recognition was different.

**When to use the Cash Basis Method**
If you are starting up your practice you may elect to use the Cash Basis Method of accounting for tax purposes. The election for using Cash Basis Method will have you pay tax on monies you received and expenses you have paid. This is a simpler method to use for taxes and again you only pay on what went in and out of your practice during the year. But be aware if a patient pays a down payment for a procedure in December but the work is performed in January; the Cash Basis Method would recognize the income in December when received, not in January when earned.

**When it is best to use the Accrual Basis Method**
From a practice management standpoint the Accrual Basis Method gives you a true picture of the financial operations. By matching revenues and expenses during the period they took place, the reader of the financial statements can have a better understanding of how the business is doing.

With the Accrual Basis Method you will not only know your cash position, but you will know other important information such as accounts receivable, prepaid expense and unearned revenue to name a few.

The basic financial analysis of the balance sheet and income statement is an important tool for practice management.

**Keeping two sets of books**
The I.R.S. allows for practices to keep their company books on the Accrual Basis Method while filing their tax return on the Cash Basis Method. When you first start filing your tax returns you must choose one method or the other. Once that choice is made of which method you are filing your return, you must continue the same method.

You can change methods, but only with approval of the IRS by filing a Federal Form 3115, Application of Change in Accounting Methods.

Although keeping two sets of books may appear to be double work, most software allows you to have both the Cash Basis and Accrual Basis Methods in your financial reporting. These types of options in software give you the best of both
worlds. You will have the simplicity and potential benefit of the Cash Basis Method while having a true picture of the practice’s financial position.

**Example 3:**
Using several transactions you should see the benefit of both methods as they relate to taxes and the financial statement.

In the first year of operation, Great Smiles produced $300,000 in total patient invoices for services performed in 2013. $250,000 was deposited in 2013 and $10,000 of that deposit represented down payments on future dental procedures.

In addition, the practice received $200,000 in vendor invoices for 2013 expenses. $190,000 was paid in 2013 of which $8,000 represented prepayment of 2014 malpractice insurance.

You have elected the Cash Basis Method for tax reporting and Accrual Basis Method for financial statement purposes. For this example, equipment purchases did not take place in 2013. The results would be as follows: (Figure 1)

The Accrual Basis Method has $40,000 more income compared to the Cash Basis Method.

The reasons are the proper matching of revenues and expenses.

Accounts Receivable of $60,000 was a result of $300,000 invoiced for 2013 services, but only $240,000 was collected for those services. The additional $10,000 in cash deposited was for the down payment of services to be performed in 2014. The unearned revenue of $10,000 is actually a liability of the practice until the service is performed in 2014.

Accounts Payable of $18,000 was a result of $200,000 of vendor invoices and expense occurring in 2013, but only $182,000 was paid. The additional $8,000 in cash payments was for a 2014 malpractice premium. The $8,000 is a current asset until properly matched with the 2014 expense.

As was stated earlier, these differences are timing differences and temporarily delay the payment of tax due to the different reporting basis.

Other considerations for taxes are depreciation expenses. The tax code allows for accelerated depreciation methods such as MACRS (Modified Accelerated Cost Recovery System), Bonus Depreciation and Section 179. These methods expense capital purchases or assets with more than one year of useful life, generally at a higher rate in the early years. These methods are not Generally Accepted Accounting Principles (G.A.A.P.).

For the Accrual basics to be in compliance with G.A.A.P., you must use straight line method of depreciation. Depreciation is uniform during the useful life of the asset.

When looking at Cash Basis statements and Cash Basis tax returns, the reader of the financial data could misunderstand the true profitability of the company. Many readers of financial statements look directly at the net income of a company and how much cash is in the bank. You should not solely focus on the net income, especially with a Cash Basis statement. The true profitability of the practice may not be represented.

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**Figure 1.**

**The Cash Basis Method Tax Return**

<table>
<thead>
<tr>
<th>Great Smiles Balance Sheet 12/31/13</th>
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<tbody>
<tr>
<td><strong>ASSETS</strong></td>
</tr>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>Total Assets</td>
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<td>Owner’s Equity</td>
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</tbody>
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<th>Great Smiles Income Statement 12/31/13</th>
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<td><strong>Patient Fees</strong></td>
</tr>
<tr>
<td>Lab fees and Overhead Expenses</td>
</tr>
<tr>
<td>Net Income</td>
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**The Accrual Basis Method Financial Statements**

<table>
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<td>Accounts Receivable</td>
</tr>
<tr>
<td>Prepaid Expenses</td>
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<td><strong>LIABILITIES</strong></td>
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<tr>
<td>Accounts Payable</td>
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<tr>
<td>Unearned Revenue</td>
</tr>
<tr>
<td>Total Liabilities</td>
</tr>
<tr>
<td>Owner’s Equity</td>
</tr>
<tr>
<td>Total Liability and Owner’s Equity</td>
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Having accounts receivable, accounts payable and other Accrual Basis accounts will show a truer picture of profitability. When looking at whether to merge, buy or sell a practice, it is good to see three years of tax returns. It is equally important to see the books and records of the practice on the Accrual Basis for the same three-year period. By looking at both, you can get a true sense of profitability, cash flow, financial obligations and tax obligations of the practice.

Do not be fooled by what your gross income is or how much cash you have in your practice bank account. You need to understand how profitable your practice is and how much of the cash in the bank is truly the practice’s and not an unpaid debt. There are too many times a vendor is not paid but the practice has the cash in the bank. This is why the Accrual Basis should always be considered a preferred method to determine profitability.

Keeping two sets of books is a good thing; you have the potential tax benefits of using the Cash Basis and the benefit of knowing the true profitability of the practice.

There are more fine points of the Cash Basis Method of reporting and the Accrual Basis Method of reporting. The objective of a basic understanding of both methods, how to identify them and when to use them have been presented.

The Cash Basis Method and Accrual Basis Method of accounting are both valuation methods for a practice. You should consult your accountant for more detail on how these methods can work for you in both taxes and practice management.

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Questions

1. Prepaid Expenses would be found on a(n):
   a. Accrual Basis Method Income Statement
   b. Depreciation Basis Method Income Statement
   c. Cash Basis Method Income Statement
   d. Financial Statement Method

2. Accrual Basis Method uses the:
   a. Matching Principle
   b. Consistency Principle
   c. Timing Principle
   d. Balanced Principle

3. The difference between Cash Basis Method and Accrual Basis Method is an example of:
   a. Statement Difference
   b. Timing Difference
   c. IRS Difference
   d. Efficiency Difference

4. The Accrual Basis Method is prepared according to:
   a. IRS Regulations
   b. Financial Accounting Standards
   c. Generally Accepted Auditing Standards
   d. Generally Accepted Accounting Principles

5. Expenses recognized when paid is an example of:
   a. Accrual Basis Method
   b. Depreciation Basis Method
   c. Cash Basis Method
   d. Financial Basis Method

6. The IRS allows a company to maintain their records on:
   a. Accrual Basis Method
   b. Cash Basis Method
   c. Both a and b
   d. None of the above

7. The Asset Category of Cash can be found on:
   a. Cash Basis Method of Accounting
   b. Accrual Basis Method of Accounting
   c. Both a and b
   d. None of the above

8. Expenses recognized when incurred is an example of:
   a. Accrual Basis Method
   b. Depreciation Basis Method
   c. Cash Basis Method
   d. Financial Statement Method

9. A difference in the Cash Basis Method and Accrual Basis Method is:
   a. Revenue and expense allocation
   b. Revenue and expense proration
   c. Revenue and expense apportion
   d. Revenue and expense recognition

10. A small business tax return could be prepared using:
    a. Cash Basis Method
    b. Accrual Basis Method
    c. Both a and b
    d. None of the above

11. Which of the following do most small businesses use when preparing year end taxes?
    a. Deferred Basis Method
    b. Accrual Basis Method
    c. Financial Basis Method
    d. Cash Basis Method

12. Revenue when received is an example of the:
    a. Accrual Basis Method
    b. Depreciation Basis Method
    c. Cash Basis Method
    d. Financial Basis Method

13. A practice can petition the IRS to change an accounting period by filing form:
    a. 1040
    b. 1120S
    c. 1065
    d. 3115

14. Accelerated depreciation would be found on:
    a. Cash Basis Tax Return
    b. G.A.P. Financial Statement
    c. Statement of Cash Flow
    d. Financial Footnotes

15. A payment of $5,000 is made on 12/28/12 for 2013 malpractice expenses. On the Accrual Basis, how much of the expense would be recognized in 2012?
    a. $5,000
    b. $2,500
    c. $0
    d. $1,000

16. Accounts Receivable on an Accrual Basis Balance Sheet represents:
    a. Total Sales
    b. Net Sales
    c. Outstanding patient invoices not yet paid
    d. Total invoices

17. Revenue recognition when earned is an example of:
    a. Cash Basis Method
    b. Depreciation Method
    c. Financial Statement Method
    d. Accrual Basis Method

18. Accounts payable on an Accrual Basis Balance Sheet represents:
    a. Total Expenses
    b. Total Cost
    c. Outstanding vendor invoices not yet paid
    d. Total Invoices

19. Lab Fees Expenses can be found on:
    a. Accrual Basis Income Statement
    b. Cash Basis Income Statement
    c. Both a and b
    d. None of the above

20. The truest view of a practice’s profitability would be found in:
    a. Accrual Basis Income Statement
    b. Cash Basis Income Statement
    c. Both a and b
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### Course Evaluation

1. Were the individual course objectives met?

<table>
<thead>
<tr>
<th>Objective #1: Yes</th>
<th>No</th>
<th>Objective #2: Yes</th>
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3. Identify Cash Basis and Accrual Basis financial statements.

4. Determine when to use these two different methods of accounting for practice management.

5. How do you rate the author’s grasp of the topic?

| 5 | 4 | 3 | 2 | 1 | 0 |

6. How would you rate the objectives and educational methods?

| 5 | 4 | 3 | 2 | 1 | 0 |

7. Was the overall administration of the course effective?

| 5 | 4 | 3 | 2 | 1 | 0 |

8. Please rate the usefulness and clinical applicability of this course.

| 5 | 4 | 3 | 2 | 1 | 0 |

9. Please rate the usefulness of the supplemental webinograpy.

| 5 | 4 | 3 | 2 | 1 | 0 |

10. Do you feel that the references were adequate?

| Yes | No |

11. Would you participate in a similar program on a different topic?

| Yes | No |

12. If any of the continuing education questions were unclear or ambiguous, please list them.

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### Participant Feedback

13. Was there any subject matter you found confusing? Please describe.

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14. How long did it take you to complete this course?

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15. What additional continuing dental education topics would you like to see?

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### Answer Sheet

<table>
<thead>
<tr>
<th>Name:</th>
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