Cash vs. Accrual Accounting For Non-Profits:
Which is Right for Your Organization?

While many commentators are suggesting that nonprofits need to adopt accrual accounting, not every Executive Director or Board Member understands the debate, or even the difference between cash accounting and accrual accounting. While it’s widely agreed that accrual better reflects the financial health of your organization, people still resist it thinking that it is too complex for nonprofits.

We think this is a misconception of nonprofits and sells them short. There are many very talented people in the nonprofit arena, and this becomes truer all the time. In fact, the recent recession drove many talented business people to seek nonprofit positions, while nonprofits have been recruiting from the business world for years. There is no denying that accrual takes more sophistication, and even some well established business owners struggle with it, but if it is a more accurate method and results in better financial health, then nonprofits owe it to their donors to make the effort.

This month, Cathedral provides an overview of the advantages of switching your organization to the accrual method, and why it makes sense for your organization.

Technical Aspect of Cash vs. Accrual Accounting

There are two general methods of accounting that nonprofit organizations have to choose from; cash method or accrual method. For some smaller organizations, it makes sense to use the cash method of accounting because it mirrors “check book accounting”. This is the same as when you balance your check book, using debits and credits as the transactions occur. This method is the simplest way of showing inflows of cash coming into the organization and outflows of cash moving out.

The cash method is the widely accepted standard for non-profits and many people never even consider the accrual method. The fact that the cash method mirrors what you do with your checkbook every month makes it comfortable for non-profit executives with little accounting experience. In addition, when cash is tight, cash method accounting is the easiest way to manage bank balances.

A basic example of the cash method is that, for example, if your organization receives a $100,000 pledge today, the cash method suggests you do not record this $100,000 until the cash is in the bank. There are certainly exceptions to this example and many readers have no doubt seen variations on the above, but the numerous exceptions and variations is part of the problem with cash basis accounting, as we will point out below. In the next section, we’ll explain how this would be recorded using the accrual method.
The *accrual method* of accounting differs from the cash method in that it focuses on recording revenue and expenses when the transaction takes place, regardless of when the cash actually moves in and out of the organization. Using the same example from the previous paragraph, the accrual method illustrates that the organization would record this pledge revenue immediately and then creates a receivables account for the outstanding cash. Expenses are recorded in a similar approach. As a bill is received, it would be recorded when it comes in the door. The payment is then recognized as a payable until an actual payment is made.

Below is an illustration of this example. Using the $100,000 in pledges, the example below assumes only $10,000 will be received in cash at the end of the first period using the cash method, but $100,000 is recognized under the accrual method during the same period. The expenses indicate that under the cash method, $20,000 in checks were written out, however, under the accrual method, this example indicates that $60,000 in bills were received, creating $60,000 in accounts payable under the accrual method.

It is important to remember that transactions may occur in one period under the accrual method that do not occur in the same period with the cash method. This example below is a basic view of how different an organization’s end of period financials can look when comparing cash vs. accrual. Click [here](#) for Cathedral’s paper on better understanding nonprofit financial statements.

<table>
<thead>
<tr>
<th>End of Period 1 Statement of Earnings</th>
<th></th>
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<tbody>
<tr>
<td><strong>Cash Basis</strong></td>
<td><strong>Accrual Basis</strong></td>
</tr>
<tr>
<td>$ Contribution Received</td>
<td>$10,000</td>
</tr>
<tr>
<td>$ Paid out for expenses</td>
<td>$(20,000)</td>
</tr>
<tr>
<td>Net Earnings</td>
<td>$(10,000)</td>
</tr>
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The main goal of the accrual method is to recognize the financials in the correct time period in which events occur, depending on when the information is reported. The illustration above shows these events occurring during different periods. The accrual method records revenues and expenses when the events actually take place providing a complete financial picture for the entire year, something that some organization’s boards and management may have not seen before. This presents a greater tool for these leaders and budgeting of the organization.

The cash method can confuse the financial picture depending on how your organization cash flows. If the organization relies primarily on one month a year for cash flow – as is often the case with end of the year giving, the cash method may not accurately portray when that revenue is taking place, but only when it comes in the door, creating a lopsided picture of the organization’s revenue. Perhaps your organization only receives a few grants a year and the checks come in the mail on the same day. From a budgeting standpoint under the cash method, the financials would only show revenues for one month during the year. On the other hand, using the accrual method, if the pledges were received in January, February, and March that would allow the organization to record the revenue in those months, better reflecting the rhythm of the organization’s fundraising. Accrual gives a better picture of when grants and pledges are “won” regardless of when they are paid. This is a basic example, but important example for understanding how to more accurately record your financials.
Variations of Cash Accounting

Cash basis accounting sounds so easy, and it would be, if indeed every transaction could be recorded only when the money changes hands, but of course, our economy does not work that way. Bills are pre-paid, pledges are made, grants are deferred, funds are held in special reserve accounts, etc. What happens to cash accounting when one of these events occurs? Accrual starts to creep in. Most accountants would agree true 100% cash accounting does not really exist. Nearly all cash basis accounting has some element of accrual in it. This phenomenon has come to be called “modified cash accounting.” Perhaps the biggest problem with modified cash accounting is that no two “modifications” are the same. There is no uniform way to run a modified cash accounting system. For this reason, GAAP does not recognize cash, or modified cash accounting. GAAP usually assumes that all activities within an organization are recorded under the same accounting method.

In fact, most nonprofit organizations that file tax returns (Form 990) usually file accrual based returns. This is due to recent changes to the new form 990. Schedule A of the form 990 requires adjustment for accruals. If a nonprofit organization is receiving an audit and wish to receive an “unqualified opinion”, the organization would be required to use the accrual method.

Should a Nonprofit Organization Switch?

As your organization grows, a more comprehensive accounting method is appropriate, not only from the aspect of auditors, but for your board and management. The size of your organization does not always indicate which accounting method to use, but it is more likely that with budgets over $500,000, the cash method begins to get more problematic as the need for accrual rises and “modified cash basis accounting” begins to set in.

It is often stated that smaller organizations without the resources or means to use the accrual method tend to lean toward the cash method for cost savings and simplicity. Anyone who has become at all familiar with the ease and inherent logic of accrual accounting will find this a somewhat dubious reason for sticking with a cash method of accounting. Perhaps this nonprofit bias for cash method is due to a small organization not having a bookkeeper or only having a treasurer that does not focus on the numbers more than once a quarter. Whether the reasons for non-profits favoring cash method is based in fact or in fallacy, it is important to consider what is best for the organization. And if you do choose to switch, keep in mind that most organizational software’s allow for a seamless switch.

And while the decision whether or not to switch may focus on the bookkeeper or treasurer, it is important to take the intended audience for your financial statements into consideration. For example, foundations and government agencies that require audited financial statements generally require financials in the accrual method since this is the only form accepted by GAAP. It is always important to remember that board and management staff must understand the method being used and need an accurate view of the organization for decision-making. Since most non-profit boards contain at least some business people, it is not unusual for the board to request the books be done on the accrual basis when otherwise very sophisticated financial professionals cannot draw their own conclusion from your books without asking many questions – questions which the Executive Director often cannot answer because of the complexity brought in by “modified cash” systems!

How Do Nonprofits Make the Change?

Using most nonprofit accounting software the switch can be rather simple, and painless. For example, QuickBooks users have the option to perform reports on the accrual basis while running on the cash basis to prepare tax returns. Click here for information on how to start running nonprofit reports using the accrual method in QuickBooks\(^3\). This link above provides basic steps to making this change.

Microsoft Dynamics (Great Plains) out of the box produces accrual method reports. For an additional add-on Dynamics allows you to create cash method reports simultaneously with the accrual method reports. Peachtree bookkeeping software is just as easy, click here for instructions on how to switch from cash to accrual using that software\(^4\).

What Should a Nonprofit Organization Do?

More and more commentators are suggesting that nonprofits move to the accrual method, and Cathedral Consulting encourages that sentiment. Cathedral suggests discussing this with the organization’s management team, committees, board members, or decision makers on what their preferred method would be for better understanding. The accrual method creates a smooth flow of financials, helping everyone inside and outside of the organization understand how the nonprofit is operating and performing. Depending on what bookkeeping software a nonprofit organization uses, they need to look at the use of the cash method and the accrual method to understand the difference on how each accounting method makes the organization look.

Additional Information and Resources:

1. Cash or Accrual? Selecting the Correct Method:  

2. Does Full Accrual Accounting Enhance Accountability:  
   [http://www.innovation.cc/scholarly-style/beechy4final1draft.pdf](http://www.innovation.cc/scholarly-style/beechy4final1draft.pdf)

3. Nonprofit Specific Bookkeeping & Accounting:  

Peter Giersch is COO and Managing Director and Michael Leppellere is a former Associate at Cathedral Consulting Group LLC in the Midwest office.

For more information, please visit Cathedral Consulting Group LLC online at [www.cathedralconsulting.com](http://www.cathedralconsulting.com) or contact us at [info@cathedralconsulting.com](mailto:info@cathedralconsulting.com).

\(^3\) Ivens, Kathy. “Running QuickBooks in Nonprofits”  
[http://books.google.com/books?id=4aoBV5mDP1QC&lpg=PA210&ots=OEHSUZ_mTe&dq=quickbooks%20non%20profit%2 0cash%20to%20accrual&pg=PA213#v=onepage&q&f=false](http://books.google.com/books?id=4aoBV5mDP1QC&lpg=PA210&ots=OEHSUZ_mTe&dq=quickbooks%20non%20profit%20cash%20to%20accrual&pg=PA213#v=onepage&q&f=false)

\(^4\) eHow, Ian. “How to Use Peachtree Software.”  