CHOOSING THE RIGHT ACCOUNTING METHOD

bookskeep
ECOMMERCE FINANCIAL SOLUTIONS

Learn the differences, benefits, and limits of the Cash, Accural, and Modified Cash Methods of accounting.

Cash Accounting Method

Many ecommerce sellers start out as small hobby businesses and enjoy the ease and simplicity of the cash method of accounting, similar to the way you manage your personal finances:

1. When you receive money from a sale, it is considered income, and
2. When you pay for a supply or service and the business cashes your check, you incur an expense.

This method allows you to easily understand your cash flow. Note: The IRS allows small businesses to operate using a cash method until the business has annual revenue of $25 million, unless they have inventory. Other stipulations may apply, so be sure to visit **https://www.irs.gov/forms-pubs/about-publication-538** and consult a tax professional.

Accrual Accounting

Because ecommerce businesses have inventory, many automatically set up to use an accrual accounting method. This is a more complicated method, requiring the business to record its revenues when the sale occurs, not when the cash is received, resulting in a two-step entry into the books:

1. At the time of the sale, an entry is made to show the revenue on the Profit and Loss report and the amount owed as a receivable on the Balance Sheet.
2. When payment (cash) is received, an entry is made to record the cash and deduct the amount of the receivable.

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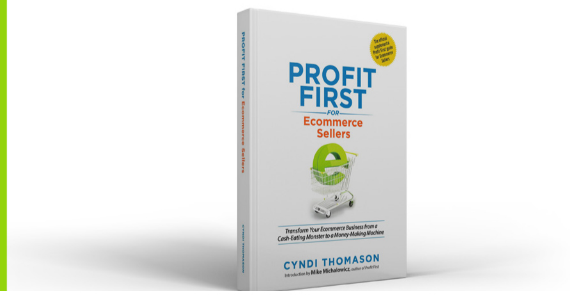

Accrual Accounting (continued)

A similar set of steps is required for expenses using an accounts payable account on the Balance Sheet. For many ecommerce sellers, the revenue and expenses are incurred and transacted through cash in a relatively short time span.

Using this method doesn't provide any better understanding of the financial standing of the business, and it adds additional steps and time to manage accounting tasks. However, understanding the longer-term impact of your inventory purchases and sales on financial performance is quite useful.

Modified Cash Method

By using the modified cash method, you blend benefits from both worlds. You can simplify your typical short-term income and expense transactions and process them using the cash method. The longer-term transactions such as inventory purchases, are treated as an accrual type transaction. This method allows you to see how profitable you were on the sales you made during the month without significantly increasing your accounting tasks.

To use modified cash for inventory:

1. Inventory is recorded as an asset when it is purchased;
2. At month end, you reduce this account with a journal entry to Inventory and Cost of Goods Sold. This gets the value of what you sold onto your Profit and Loss report and removes the inventory sold from your inventory account on the Balance Sheet.