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What's the difference between cash accounting and traditional accounting?

When you start a new business, you need to make several decisions. One of the most important decisions you'll make is whether to use the cash basis accounting method or the traditional accounting method.

Cash basis accounting

Cash accounting, also referred to as cash basis accounting, records financial events when payment is made or received, rather than when an invoice was sent.

Cash accounting is best suited for small businesses because you only need to declare money when it comes in and out of your business.

You can only use the cash accounting method if you run a small self-employed business with a turnover of less than £150,000 a year. Limited companies and limited liability partnerships cannot use cash accounting.

Cash accounting is the default basis for landlords. If a landlord wishes to use traditional accounting on their Self Assessment, they will need to select that option on their tax return.

VAT cash accounting

The VAT Cash Accounting Scheme follows the principles of cash accounting. This means that you pay VAT on your sales when your customers pay you, and you reclaim VAT on purchases when you have paid suppliers.

For many businesses, the scheme improves cash flow as you do not pay VAT until you receive payment from your customer. To join the scheme your VAT taxable turnover must be £1.35 million or less.

Traditional accounting

Traditional accounting, also known as accrual accounting, records financial events right when they happen, rather than when payment is made or received.

In other words, an income or expense is recorded for tax purposes when the job is ordered, even if you have not received or sent the money.

Limited companies and limited liability partnerships must use the traditional accounting method.

This is because directors of companies must prepare a balance sheet and a profit and loss account that give a true overview of the state of the company at the end of the financial year. To have a complete overview, they must enter all sales and purchases in the accounts, not just the ones that have been paid.

Traditional accounting portrays a more accurate statement of the company's health and makes it easier for senior management to create budgets and plan for the future.

Example

As an example, a construction business provides a £5,000 service to a client on 30 October. The client receives the bill for the services rendered and makes a cash payment on 20 November.

Under the cash accounting method, the transaction will be recorded in their books on 20 November. Under the traditional accounting method, the transaction would be recorded on 30 October.