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Congress of the United States
U.S. House of Representatives
Committee on Small Business

2361 Rayburn House Office Building
Washington, DC 20515-6315

Memorandum

To: Members, Subcommittee on Economic Growth, Tax and Capital Access
From: Committee Staff
Date: July 7, 2014
Re: Hearing: "Cash Accounting: A Simpler Method for Small Firms?"

At 10:00 a.m. on Thursday, July 10, 2014, the Committee on Small Business Subcommittee on Economic Growth, Tax and Capital Access will examine the benefits and costs of cash accounting for small businesses. Cash accounting allows businesses to record income and expenses at the time the funds are received or paid – nearly identical to the operation of a consumer or business checkbook. Such methods may be simpler for small businesses than alternative accounting regimes, but small business utilization of cash accounting is restricted by the Internal Revenue Code (IRC or Tax Code) and various regulatory pronouncements of the Internal Revenue Service (IRS). In particular, the hearing will examine whether current policies should be changed to allow small firms more flexibility in using an accounting method that best suits their operations.

I. Introduction

When tracking and reporting income and expenses, small business owners must determine the type of accounting method their business will employ.[1] Generally, they use either the cash accounting method or accrual accounting method, and in some instances, a combination of the two.[2] Whichever method a small business decides to use, either out of choice or because of the law, it will naturally have a tangible effect on the outcome of its operations as the IRC dictates that a business must compute taxable income based on the method of accounting it uses to regularly keep its books.[3]

Businesses that use the cash accounting method record income and expenses only at the time funds are received or disbursed.[4] For instance, if a business provides a service or good to a client in December of this year but does not receive payment for this transaction until January

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[1] DEPARTMENT OF THE TREASURY, INTERNAL REVENUE SERVICE, PUBLICATION 334, TAX GUIDE FOR SMALL BUSINESSES 12 (2013), *available at* http://www.irs.gov/publications/p334/ch02.html#en_US_2013_publink1000313233 [hereinafter Small Business Tax Guide].
[2] *Id.*
[3] 26 U.S.C. § 446(a).
[4] http://www.sba.gov/community/blogs/community-blogs/small-business-cents/cash-vs-accrual-accounting-taxable-income-and-e.

2015, the income is recorded for 2015.[5] The same logic holds true for the accounting and recording of expenses.[6] With the accrual method of accounting, income is recorded at the time a sale is made or an agreement to provide a service is reached, regardless of when the incoming funds are actually received.[7] Likewise, expenses are recorded when they are obligated to be paid, regardless of when the funds are disbursed.[8] Using the accrual method, a business that made a sale or agreed to provide a service to a client in December of this year would record that income for 2014, even if the payment is not received until 2015.[9]

The cash method of accounting is significantly more popular for small businesses. According to the National Federation of Independent Businesses, 41 percent of small businesses use cash accounting, while only 19 percent employ the accrual method, and another 12 percent use a combination of the two.[10] Interestingly, 28 percent of small businesses surveyed did not know which method they used,[11] suggesting that they are also likely using a form of cash accounting, recording income and expenses as they happen. Given the simplicity of cash accounting and the obvious benefit of the business paying federal income tax on monies already received, it is not surprising that it is the preferred method for small business. However, its use is restricted by the Tax Code and IRS rules.

II. Rules on Cash and Accrual Accounting

In general, the IRC requires that businesses in the United States use the accrual method of accounting for cash receipts and disbursements, but provides exceptions for certain types of businesses[12] or for businesses whose annual gross receipts fall below a certain threshold.[13] In general, cash accounting is permissible for most businesses which average less than $5,000,000 in annual gross receipts during the previous three years.[14] There are different limitations for farm business use of cash accounting depending on its ownership structure.[15]

The IRS also issues notices and rulemakings that further interpret the statutory provisions governing the use of cash or accrual accounting methods. One example is IRS Revenue Procedure 2001-10, issued in January 2001, which exempts from the aforementioned general requirement to use accrual accounting those businesses that hold an inventory but have averaged less than $1,000,000 in annual gross receipts since 1998 and have not exceeded average revenues

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[5] *Id.*
[6] *Id.*
[7] *Id.*
[8] *Id.*
[9] *Id.*
[10] http://www.411sbfacts.com/sbpoll.php?POLLID=0050.
[11] *Id.*
[12] For instance, certain pass-through entities, partnerships and S-corporations are permitted to use the cash method of accounting. 26 U.S.C. § 448(a).
[13] *Id.* at U.S.C. § 448(b).
[14] *Id.* at U.S.C. § 448(b)(3),(c)(1).
[15] A farming business that is not family-owned is exempt from the requirement to use cash accounting if in every year since 1975, it has not had gross receipts of more than $1,000,000, while family-owned farms are exempt if in every year since 1985 they have not had gross receipts of more than $25,000,000. *Id.* at § 447(d)(1)-(2)(A)(ii).

of $1,000,000 during the previous three years.[16] Just over a year later, in May 2002, the IRS issued Revenue Procedure 2002-28, which exempts from the requirement to use accrual accounting certain small businesses with up to $10,000,000 in average annual gross receipts for the previous three years.[17] To be able to use cash accounting under this exemption, a business must not be specified as one that cannot use cash accounting under the IRC, which eliminates all C corporations; it must have never used the accrual method; and it must fall within the scope of a limited number of eligible industries.[18]

III. Advantages and Disadvantages of Accounting Methods

Whether a business employs the cash or accrual method of accounting, either by choice or as required by the IRC and regulations interpreting the Tax Code, distinct advantages and disadvantages are associated with each. It is prudent to further examine specific pros and cons of each method of accounting and look at examples of benefits and drawbacks.

a. Cash Method of Accounting

1. Advantages

The primary and most evident advantage of cash accounting for small businesses, particularly as it relates to the accrual accounting method, is its simplicity.[19] In particular, it does not require either formal accounting or financial training to understand, nor a trained bookkeeper or accountant to implement.[20] Additionally, the use of cash accounting allows a business to reflect in its books the actual money that a business pays and receives over time, enabling business owners to have a strong grasp on the all-important cash flow of the business.[21]

Cash accounting also can help a small business easily sort cash income and expenses into various use categories, as well as help investors, analysts, and the business owner to be more perspicacious at spotting trends in the financial status of the company, such as a business that incurs high labor expenses in the summer but that may have flat sales during the same period.[22]

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[16] DEPARTMENT OF THE TREASURY, INTERNAL REVENUE SERVICE, REVENUE PROCEDURE 2001-10, Jan. 8, 2001, *available at* http://www.irs.gov/pub/irs-utl/revenue_procedure.pdf. While this IR-issued Revenue Procedure is seemingly in contradiction with the requirements in the aforementioned IRC, pursuant to the Code of Federal Regulations, the Commissioner of the IRS may authorize a taxpayer to adopt or change to a method of accounting permitted although the method is not specifically described in the regulations if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. 26 C.F.R. § 1.446-1(c)(2)(ii).
[17] DEPARTMENT OF THE TREASURY, INTERNAL REVENUE SERVICE, REVENUE PROCEDURE 2002-28, Jan. 8, 2001, *available at* http://www.treasury.gov/press-center/press-releases/Documents/28.pdf. As mentioned above, pursuant to 26 C.F.R. 1.446-1(c)(2)(ii), the Commissioner of the IRS has the authority to adopt or change a permitted method of accounting.
[18] The use of this exemption is not applicable to a business involved in the mining, manufacturing, wholesale trade, retail trade, or information industries. *Id.*
[19] http://www.business-case-analysis.com/cash-basis-accounting.html.
[20] *Id.*
[21] http://smallbusiness.chron.com/cash-flow-accounting-advantages-20936.html.
[22] *Id.*

This characteristic of cash accounting makes it easier to perform other financial analyses and create balance or net worth statements since they use much of the same cash-based data.[23]

An advantage of cash accounting becomes evident in the example of a business that performs a service in December of 2014, but is paid in January 2015. Using cash accounting, the business does not have taxable income for that service in 2014 (assuming that the business uses the calendar year for calculating its federal income taxes). However, with the accrual method of accounting, the business owner that performs the service realizes taxable income in 2014 even though the cash is not received until 2015. Most small businesses, particularly when operating on thin margins, would prefer to pay taxes with cash already received rather than on the expectation of receiving that cash.

2. Disadvantages

While the simplicity of cash accounting brings the numerous aforementioned advantages to small businesses, it can sometimes lead to oversights. For instance, the use of cash accounting may lead to an incorrect assumption regarding future performance.[24] Investors or creditors looking at a company's financial statements from the first year of operations might interpret negative cash flow as a problem with that company's ability to generate future cash flows. However in the next two years, that same company may in fact have a positive cash flow.[25] By the same token, a company's performance over time may appear uneven, when in actuality sales were earned evenly each year, only the collection of payment from customers was not.[26]

Additionally, the cash method of accounting may show a misleading picture of long-term profitability. Under the cash method, a small businesses' financial statement may show one month to be spectacularly profitable, when in reality sales have been weak but by coincidence a high number of customers paid bills during that time.[27]

b. Accrual Method of Accounting

1. Advantages

An often-cited advantage of accrual accounting is the ability of a business to deduct expenses earlier than with the cash method. Using the accrual method of accounting, a business can deduct an expense applicable to the tax year of the agreement to incur the expense, even though the actual outlay of cash may be made in the following year. An example is a business that is billed for and receives office supplies in December 2014 but does not pay the bill until January 2015. Unlike with the cash method, the business can deduct the expense of the office supplies in its 2014 tax return.

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[23] *Id.*
[24] ROBERT LIBBY, PATRICIA LIBBY, DANIEL SHORT, FINANCIAL ACCOUNTING, 104-05 (8th ed. 2014).
[25] *Id.*
[26] *Id.*
[27] http://www.nolo.com/legal-encyclopedia/cash-vs-accrual-accounting-29513.html.

The accrual method also is considered a better predictor of profitability of a business than a measure of cash flows.[28] Hence, use of the accrual method is currently required of all businesses under the Generally Accepted Accounting Principles (GAAP), which are required by the Financial Accounting Standards Board and are often used by those analyzing a business's operations and financial statements.[29]

2. Disadvantages

The use of accrual accounting has a variety of drawbacks for businesses, particularly small businesses that are not as well equipped to take on an increased amount of bookkeeping. Beyond diverting the owners from other important tasks of running their businesses, the more rigorous bookkeeping associated with accrual accounting is significant when compared to the cash method. For example, with the cash method, a business must only track when it makes or receives a payment, but with the accrual method, a business would have to track and record both the date a sale is made and the date payment is received.[30]

Just as significant to a small business is the chance that the use of the accrual method could lead to an inaccurate representation of free cash flow - often considered the most crucial financial element of a business and the lifeblood of a company.[31] Even if a business has recently made a high number of sales, it may not have received payment, and therefore has less cash in its account than its revenue stream shows.[32] By the same token, another disadvantage of a business's use of the accrual accounting method is that cash is not available until customers pay their bills, and in the case where they do not pay or are delinquent on payment, the business will be forced to collect on debts in order to reconcile its records, or write off the payments as a loss, which is even worse for the business.[33]

IV. Conclusion

While there are advantages and disadvantages associated with employing each type of accounting method, the method used can have very real effects on how small businesses operate and analyze their performance. Given this, it would be in the interest of small businesses to use the method that lends itself to increased operating efficiency, whichever it may be. However, the constraints of the Tax Code and IRS regulations make it difficult for small businesses to select the optimal accounting methodology appropriate for their needs.

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[28] CARL WARREN, SURVEY OF ACCOUNTING 104 (2014).

[29] http://www.fasb.org/home. It is also required of any business that seeks to sell shares to the public. *See* Bryan Snellman, *Private Placement Accounting Issues*, in PENNSYLVANIA BAR ISNT., PRIVATE PLACEMENT OF SECURITIES 274 (2012) (noting requirement that the Securities and Exchange Commission requires use of GAAP in the preparation of various public offerings of stock).

[30] http://www.sba.gov/community/blogs/community-blogs/small-business-cents/cash-vs-accrual-accounting-taxable-income-and-e.

[31] It is difficult to overstate the importance of free cash flow to a company. As one example, a spokesperson at Amazon.com, a multi-billion dollar company, once said "[w]e think all the GAAP numbers are important, but the one management is most focused on is free cash flow." CHARLES W. MULFORD, EUGENE E. COMISKEY, CREATIVE CASH FLOW REPORTING: UNCOVERING SUSTAINABLE FINANCIAL PERFORMANCE 345 (2005).

[32] *Id.*

[33] ROBERT RODGERS, PETER LUCAS, BOOKKEEPING & ACCOUNTING ESSENTIALS 20 (2011).