CASH BASIS METHOD VS. ACCRUAL BASIS METHOD OF ACCOUNTING AND ITS APPLICATIONS IN THE MANUFACTURING BUSINESSES

by

Yil wha Chung

A THESIS

Approved:

Committee

Approved:

Dean of the College

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by

Yil wha Chung

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Purpose

It was the purpose of this study to clarify the differences between the cash basis method and the accrual basis method of accounting and its applications for tax purposes in the various manufacturing businesses in the United States of America.

Methods

This investigation was done largely through research in the Estill Library, and questionnaires to leading manufacturing businesses.

References consisted of (1) the law itself, (2) articles written by experts attempting to interpret the law, and (3) the Commerce Clearing House Tax Reporter and related material.

Findings

It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income.

But where inventories are necessary to compute income, an accrual method must be used for purchases and sales, unless the Commissioner authorizes another method which clearly reflects income.

Use of the cash basis, generally means the use of a hybrid system, with sales, purchases, depreciation, and bad debts being reported as on the accrual basis, but with the remaining income and expense items being measured on a cash basis without regard to accrued and prepaid items. The cash basis offers certain advantages in the form of simpler and more economical bookkeeping.

Approved:

Jean D. Neal

Supervising Professor

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CHAPTER I

INTRODUCTION

Before a business can make an intelligent decision whether to adopt a cash basis method or an accrual basis method of accounting, it must know two things:

(1) How are income and deduction items handled under each method of accounting?

(2) What are the advantages and disadvantages inherent in each method of accounting?

The primary objective of tax planning strategy is to save taxes. This can be done by selecting the best method of accounting from among the various alternative methods which the tax law offers.

The method of accounting that the taxpayer elects determines the year in which he has to report income and the year in which he has to take deductions for expenses and losses allowed by law. The most important element in the various accounting methods available to a taxpayer is the matter of timing. By controlling the time, that is, the taxable year in which he has to report items of income and deductions, the taxpayer can avoid principal causes responsible for swollen taxes--the bunching of large amounts of income in a single taxable year which generates heavier taxes because it exposed the taxpayer to

higher surtax rates under our system of progressive income taxation.

Statement of the Problem

One of the problems confronting business firms in the selection of an accounting method is a dichotomy between good accounting procedures and tax law requirements. There are many accounting procedures which are acceptable in financial accounting that are contrary to provisions of the Internal Revenue Code.

Purpose of the Study

It is the purpose of this study to clarify the differences between the cash basis method and the accrual basis method of accounting and its applications for tax purposes in the various manufacturing businesses in the United States of America.

Limitations of the Study

No attempt was made in this study to cover all of the methods of accounting. It is limited to a discussion of two methods; the cash basis and the accrual basis.

Method of Investigation

This investigation was done largely through research

in the library, and questionnaires to leading manufacturing businesses.

The references consisted of (1) the law itself, (2) articles written by experts attempting to interpret the law, and (3) the Commerce Clearing House Tax Reporter and related material.

CHAPTER II

CASH BASIS METHOD

Cash Basis Defined

Accounting on the cash basis means that net income is determined by (a) including income and gains actually or constructively received and (b) deducting those expenses actually or constructively paid, losses sustained, and allowable depreciation or amortization for the period.

Net income on a cash basis could be the excess or receipts over payments; but this generality is subject to many exceptions.

First, not all receipts are income. Cash may be received as capital investment, as a loan, from the sale of fixed or investment assets with no element of income or gain.

Second, not all disbursements are expenses; e.g., distributions or withdrawals of capital or earnings, purchases of fixed assets or investments, repayment of loans, and so on.

Third, property having a fair market value may be transferred in lieu of cash.

Finally, there is the question as to what constitutes a receipt or disbursement for the year.

Basic Principles of Cash Basis Method

Under the cash basis method, it makes no difference when the income was earned; the year of receipt is controlling. Thus a payment of salary is taxable when received even though the services were rendered in a prior year or may have to be performed in a subsequent year.

If a taxpayer on the cash basis receives shares of stock or other property in payment for his services, he has to include the fair market value of the stock at the time of receipt in his gross income for the year in which the stock was received. The rule also applies to income items not actually received by the taxpayer but which are available to him or subject to his control. Cash items are treated as the equivalent of actual receipt under the doctrine of "constructive receipt."[1]

The most important applications of the cash basis in practice, as a variation from the sale-standard, are found in enterprises furnishing services rather than goods and in concerns making sales on the installment plan.

If the unit of service furnished consists of a definite act or condition supplied in a short-time period, as is generally characteristic of such industries as transportation and amusement, collection from the customer or patron usually occurs at about the time the service is

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[1] William J. Casey, Tax Shelter in Accounting, Institute for Business Planning, 1957, p. 37.

rendered. This means that either the test of furnishing or the test of collection is available as a basis of revenue measurement. If, on the other hand, output is in the form of a complex of services furnished over a considerable period, as in the case of a professional engineering or accounting engagement, or is defined by contract in relatively long time units, as in the case of granting the use of a building at an annual rental, there is likely to be considerable variation between the periodic amounts of revenue based on the process of furnishing and the amounts based on cash receipt. The questions arises: Is the cash basis peculiarly preferable to the sale basis for these situations? In general, a negative answer is justified. Claims derived from service rendered have substantially the same legal standing as accounts receivable originating in sales of tangible goods. It is to be doubted, moreover, whether experience shows that collection is any less likely in the case of services furnished on account than in the case of commodities delivered on credit. If collection is made in advance, as is common in some service lines, the possibility of bad debts is eliminated and the accruing of revenue in terms of service rendered becomes imperative if downright misstatement is to be avoided. There remains, on the other side, the fact that in some cases the furnishing of service may be a less convenient occasion for booking revenue than the sale of goods. This is particularly true

of professional services for which the character of the work to be done cannot be precisely determined in advance and the total amount to be billed is likewise uncertain until the engagement has been completed.

The argument supporting the use of the cash basis of measuring revenue for sales of goods on the installment plan rests mainly on three related considerations: (1) the receivables involved are at least in part far removed from availability as purchasing power; (2) the possibility of failure to collect is increased by the length of the terms of settlement; (3) the "after-costs"--largely billing and collection expenses--are higher than in the case of short-term credit sales. Of these points the first is probably the most significant; to the extent that "revenue" implies an inflow of highly liquid assets, long-term receivables are an unacceptable evidence of revenue. The validity of the second point is questionable. The down payment invariably made by the installment buyer tends to give the installment sale some advantage over the ordinary account sale with respect to certainity of collection in full and the type of contract typically employed, under which the vendor retains title, facilities recovery of goods in event of default. Further, the device of establishing an allowance for possible bad debts is available to the concern selling on the installment plan if it is desired to measure revenues

in terms of sales. With respect to the third point it may be said that the problem of adjusting sales revenue in the amount of costs yet to be incurred is much the same whether the amount be small or substantial.[2]

In practice most schemes of cash revenue accounting are unsatisfactory in that they fail to provide for a clear-cut reporting of the total amount of revenue on a cash basis and also fail to provide for an assignment of all operating costs to revenue in a reasonable manner.

A more satisfactory accounting for this situation is easily developed. The adoption of cash receipt as a means of measuring revenue is tantamount to exclusion of installments receivable from the family of reportable assets. Such receivables, therefore, should be set up in memorandum self-balancing form. In the financial accounts proper the total amount of cash collected each period should be credited to "revenue on cash basis." It may also be desirable to transfer the assembled costs of product sold and delivered on contract to a special account. At the close of the period "production costs applicable to cash revenue" should be charged with the proper amount and "equity of customers in delivered product" credited. On the basis of this accounting, total cash revenue is reported in the income sheet with production and all other costs applicable. In

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[2] W. A. Paton and A. C. Littleton, An Introduction to Corporate Accounting Standards, AAA Monograph No. 3, 1940, p. 58.

the balance sheet product delivered under contract is shown at production cost, with the equity of the buyer being shown either as a liability or as a deducted contrast, as preferred.

Mention was made above of the fact that conventional practice does not provide for a reasonable assignment to revenue of costs not assembled in production or inventory accounts, that is, general administrative and selling charges. It may be urged that if revenue is to be measured by cash receipts the assignment of costs should be in harmony with this position. In other words, if revenue is distributed periodically in terms of collections, all costs incurred should be correspondingly apportioned. This recommendation conflicts with the usual attitude of the accountant to the effect that general overhead and distribution costs are not inventoriable and should not be deferred. But it should be remembered that this attitude has been established without reference to the cash basis of measuring revenue. As was pointed out earlier, the essential task of accounting is a rational matching of costs incurred with resulting revenues. Therefore, if the revenue associated with a particular sale is spread over two or more periods of reckoning it is clear that the costs associated with such sale should be similarly spread. It is particularly at this point that attempts at a satisfactory accounting for income on a cash basis are usually subject to improvement.

Receipts, Constructive Receipts, and Income

Cash includes not only money but also commercial paper redeemable in money on demand such as money orders, bank drafts or checks. It does not include notes or similar promises to pay money at some future time. The general rule is that a bank check received constitutes an actual or conditional receipt, even though the holder refrains from depositing or cashing the check until a later date. However, acceptance of a post-dated check, or one which can not be cashed because the maker now has insufficient funds on deposit, is not a cash receipt. It follows that a worthless or forged check is no receipt.

Transactions near the end of the year call for decision as to the exact time receipt occurs. For example, it has been held that a check received after banking hours on December 31 constitutes a receipt for the current year. On the other hand, a check mailed on December 31 in the usual course of business but not received until January is a receipt of the later year. A debatable situation is receipt by credit such as on a bank savings account. The general rule is that income is received when set aside or credited without any restriction as to withdrawal. In practice the interests on savings accounts is credited as of the close of business December 31 although seldom entered in the passbook on that date. Nevertheless, such interest usually is included in income as of December 31.

Generally, a cash basis taxpayer is taxed only on income actually received in cash or property. Under the doctrine of constructive receipt, however, a taxpayer may be taxed on income even before it is actually received, if it is his for the asking.

The purpose behind the rule is to prevent a taxpayer from escaping or minimizing taxes by deferring the receipt of income to a year that is more beneficial to him tax-wise.

The most common examples of constructive receipt are: matured interest coupons on bonds which have not been cashed, declared dividends unqualifiedly subject to the stockholder's demand, and interest credited on savings bank deposits although not withdrawn.

A taxpayer may not deliberately turn his back on income and thus select the year in which he will report it. In one case, the taxpayer refused to accept payment of a note tendered to him because he wanted to postpone taking into income an installment of profit and interest on the note.

In another case, a retired employee refused to accept a pension and retained uncashed the pension checks that he received. The checks were held to be taxable income constructively received.

Given a note is not payment. But if money is first borrowed, then used to pay expenses, the deduction can be taken.

Cooperation by customers, clients, suppliers or vendors whose interests are not adverse to ours can help our tax accounting. But this cooperation may not be easy to get. For instance, income constructively received is taxed at once to the cash basis recipient; but this does not automatically give the payor a deduction on the theory of constructive payment. This difference in accounting treatment makes it difficult sometimes for the two taxpayers to get together on an arrangement that will be mutually beneficial.

The fact that a cash basis taxpayer does not withdraw profits from a brokerage account will not postpone taxation of the profits. They are taxable in the year earned, even though they were wiped out by losses in subsequent years.

The principle most frequently quoted in these cases on constructive receipt is the dictum of Mr. Justice Holmes in Corliss v. Bowers 281 U.S. 371 (1930): "The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not."[3]

There is constructive receipt where:

1. Salaries are credited to an officer on the corporation's books.
2. A corporate resolution authorized an officer's salary and fixed the time it was to be paid.

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[3] William Casey, Tax Shelter in Accounting, p. 39.

3. Agreement calls for payment this year. Check is mailed to him this year, but he does not receive it until nest year. One court says he has income this year.
4. Dividend checks are issued this year. He, the stockholder, asks the corporation to hold his check until next year. He has income this year.
5. Money is paid to a court receiver as purchase price of his property. But payment to him is held up because a creditor attaches the payment.
6. His selling agent collects this year. He cannot get the money until next year. He has income this year.
7. A broker receives dividends on stock he owns--although he does not know he owns it.
8. There is a book entry, but the one owing the money has no cash. He offers to borrow it to pay but is told not to. There is income anyway.

There is no constructive receipt where:

1. Amounts are set aside if he is on an accrual basis. Constructive receipt never applied here. The ordinary accrual basis rules apply.
2. A book entry is made in a reserve account--if the account is not payable below.
3. Corporate resolution authorizes salary to an officer but not stating when it is to be paid. It makes no difference that the officer has the power to pay himself. A book entry or other act of payment is needed for constructive receipt.

4. Contract calls for payment next year, even if you could have secured payment this year if you wanted it.
5. Money is put in escrow--which he cannot get until a tax lien on property he sold is removed.
6. Condemnation award is deposited in court. It could not be withdrawn until there was a court order and a showing of clear title free from tax and judgment liens.
7. Although book entry is made, the one owing the money has no cash and makes no move to borrow it. Then the cash is not available--so no constructive receipt.[4]

The income of a sole proprietorship, or a partner's share of business income, is income to the individual on a cash basis whether or not actually withdrawn. Similarly, compensation for services credited to the account of a company and subject to withdrawal at any time is income constructively received on the cash basis.

The negotiable note of a solvent third party may be treated as income on a cash basis to the extent of its fair market value if such note is accepted as payment or as discharge of the liability for services. Any difference between face value and present value, or discount, will be income when cash is realized. On the other hand, if a note is received merely as security for or as evidence of an obligation there is no income on a cash basis at the time of receipt of the note. The main point here is whether

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[4] Casey, op. cit., p. 40.

something other than money has been accepted as cash receipt. If so the fair market value of the thing taken as payment is the amount to be included in income on the cash basis.

For income tax purposes an exception to the general rule of receipt is the election permitted, under section 42(b) of the Internal Revenue Code, to report the periodic increase in redemption value of obligations such as U. S. Savings Bonds as income on the cash basis even though not actually received by redeeming such obligations during the year.[5]

A problem facing the accountant is proper statement presentation of accounts receivable from customers or clients where income is computed on the cash basis. An example is amounts currently receivable for services rendered but not yet reported as income because not collected. The balance sheet would be incomplete if this asset were ignored. One solution would be to add a footnote stating the estimated collectible amount of receivables. A better method is to include offsetting amounts in the balance sheet by adjustment thus:

Current Assets:	
Accounts receivable, estimated collectible	$23,000
Deferred Credits:	
Unrealized gross income on cash basis	$23,000

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[5] The Accounting Review, July, 1954, p. 494.

The above applies only to receivables arising from income transactions. On an accrual basis entry would debit the receivable and credit income; but on the cash basis, income is not to be credited until cash is realized. Other receivables arising from non-operating sources, such as a cash loan, will be included in the balance sheet whether income is on a cash basis or accrual basis. The original entry would be a debit to loan receivable and credit to cash; that is, only balance sheet accounts are involved.

A similar situation is a sale of investment securities held by a business not a dealer in securities. If legal title has passed at the end of the period but the price has not been collected (therefore gain cannot be reported on a cash basis) some entry similar to the following seems proper:

Accounts receivable (selling price)	120,000	
Investment securities (cost)		90,000
Unrealized gain on sale		30,000

Subsequently collection would require a debit to cash and a credit to the receivable, also a debit to unrealized gain and credit to realized profit on the sale of this investment asset. Notice that if the securities had been sold at a loss the entry could set up unrealized loss as a deferred charge until the cash was received.

Expenses and Payments

On the cash basis, expenses usually are deducted

in the year paid. As previously mentioned, however, not all disbursements are expenses. Just as the source of cash receipts must be established, so the reason for cash disbursement must be established. Further, it is possible to transfer property having a fair market value in lieu of cash payment; cash may be constructively paid; and deductions such as depreciation do not require current cash disbursement.

Whether an expense paid relates to income already received or to be received in the future is immaterial. However, in practice the income tax rule may be followed; that is, expenses are deducted in the year paid unless the deduction must be accounted for in a future year in order to clearly reflect net income. Thus, if a business signs a three-year lease and prepays rent for the entire three years the total amount cannot be treated as current expense in arriving at acceptable results either for profit and loss or balance sheet purposes. This means that the cash basis in practice may at times be a hybrid of cash and accrual method, but departure from a strict cash basis seems justifiable for unusual situations.

Payment may be made in cash or its equivalent such as a bank check, money order or similar commercial paper. Merely writing a check is not sufficient. The check must be issued and, further, it must be paid upon presentation to the bank. For example, a check given which does not clear

because of payment being stopped, insufficient funds on deposit, or similar reasons does not constitute payment. However, a check issued on December 31, which clears in January, is considered payment on December 31.

A note issued, being merely a promise to pay at some future time, is not payment. On the other hand, if money is borrowed on a note payable, the fact that expenses are paid with the borrowed money does not prevent deduction of expenses on a cash basis. Expenses also may be paid by transferring property having a fair market value if accepted by the creditor in lieu of cash payment and not merely as security for future payment.

The doctrine of constructive payment is applied only to those cases where payment clearly occurs. As an example, if $10 interest owed is credited to the account of the creditor-debtor who owes $30 and the net amount of $20 is collected, this obviously is the same as collecting $30 and paying the $10 interest. On the other hand, merely crediting a liability account or issuing a note for an expense due is not payment.

In preparing the balance sheet for a business reporting on the cash basis it may be desired to show the liability for unpaid expenses. An acceptable method is to include offsetting amounts in the balance sheet for deferred charges and the expenses payable. This could be treated as

balance sheet adjustment with no effect on the ledger account or the computation of net income. In the following period the usual entries would be made debiting expenses accounts and crediting cash. Regardless of whether income is computed on the cash basis or an accrual basis, expenditures during the year must be properly classified between capital or assets and expense. It follows that expenditures for land, buildings, equipment and the like items having a useful life of more than a year should be treated as assets subject to applicable depreciation, amortization or depletion. In other words, income on the cash basis is reduced by depreciation or similar allowances in the same manner as on the accrual basis.

Do not overlook long-term deferred charges of sizeable amount and allocable to future years, such as leasehold bonus and improvements, bond discount or issuance expenses, organization expenses and similar asset items. While this may be a departure from a strict cash concept, it is the procedure actually followed in computing net income on a cash basis.

Uncollectible amounts receivable from clients or customers, arising from ordinary business operation, are not deductible as bad debts on the cash basis. The reason is that such receivables have not been reported in income there is no bad debt deduction. On an accrual basis the receivables would have been debited and income credited,

therefore a deduction of bad receivables from reported income is proper. Notice that on the cash basis the business already had deducted any operating expenses paid that might be traceable to the uncollectible receivables.

Other types of losses, such as non-business bad debts or casualty losses, are proper deductions on the cash basis. These represent losses of recognized assets rather than of unreported income. A note receivable representing a cash advance, or an investment security, is deductible as a loss when determined to be worthless. The destruction of property by fire, storm, or other casualty represents deductible loss, to be offset by insurance or other recovery. It shall be noticed that if insurance proceeds should exceed book value of the property a gain could result.

Advantages of Cash Basis Method

Accountants agree that use of the cash basis by a business dealing in goods is not to be recommended. A firm or business dealing in services, however, may find that the cash basis both realistic and acceptable. This is particularly true for the professional firm, and for corporations conducting operations in which inventories are not an income-determining factor. The cash basis also is acceptable for companies whose income is derived primarily from investments. From a business viewpoint the net income,

after taxes, on a cash basis more nearly coincides with net money income from which distributions or expenditures can be made.

One of the criticisms commonly directed against the cash basis is that expenses are not necessarily paid in the period for which incurred and that income is not always collected in the period in which earned. For annual or semi-annual accounting periods, this criticism loses much of its sting. The average business makes many payments of expenses and has numerous receipts of income during the year. There will be some over-lapping of items from year to year, but the same is true of the accrual basis to a lesser degree. In those instances where heavy expenditures apply to future years it already has been indicated that the charges may be deferred. Advance receipt of a large amount of unrestricted income presents a problem. Income tax statutes emphasize receipt rather than the earning of income, hence the amount may be taxable in its entirety in the year of receipt on either the cash or accrual basis. In practice, most businessmen are well aware of the tax rule and therefore either restrict advance receipts so as to constitute a present liability, or simply arrange to receive cash income in several installments rather than as a lump sum.

The cash basis is best adapted to business operations involving numerous receipts and payments during the year.

Under these circumstances the bulk of expenses will be matched with income. All factors should be carefully weighed before deciding whether the cash basis is a suitable method of accounting for a business organization. In other words, it should not be assumed that the accrual basis is superior to the cash basis in all cases. It is a valuable experience for any accountant to try to explain to the businessman how he made thousands of dollars net profit for the year, on an accrual basis, but must struggle to find the cash to pay past-due bills!

Objections to Cash Basis Method

Cash accounting for revenue tends to prolong the period between production and the recognition of earnings, and hence does not commend itself to the managerial point of view. Under the cash basis, moreover, the difficulty of matching revenues with applicable costs is increased. If revenues are based on receipts and there is no appropriate adjustment of expense accounting, unreasonable periodic results are likely to emerge.

If incomes are received in a period earlier than corresponding expenses are paid the effect of handling them on a cash basis will be to increase the net income of the earlier period and to decrease that of the later period. One period might show a net gain and the other a net loss

when as a matter of fact the operations of the two periods were the same except for the dates of cash receipts and payments. The inadequacy and impropriety of such a method is particularly evident in corporate business where directors as well as stockholders are so largely dependent upon accounting records for their judgment of the profitableness or unprofitableness of periodic operations.

In the field of real estate development, for example, commissions and other selling costs are largely incurred in the period of sale, although the major portion of the selling price of a lot may be collected in subsequent periods. With these conditions the equitable procedure, under the installment method of reporting income would be to spread the selling charges over the series of receipts from buyers rather than to absorb the entire amount against the collections of the period of sale.

Even if the cash basis is appropriately adopted it would not be proper to include in revenue the receipt from customers received prior to the furnishing of service or sale of goods--sometimes referred to as "deferred revenue." Credit balances of this sort should be entirely excluded from the income statement and should be reported as liabilities in the balance sheet. The funds deposited are fully covered by the obligation to the customer and afford no support for a credit to revenue until delivery of goods or

services as agreed; in the event that the vendor is unable to make delivery the entire amount must be returned. Upon performance by the vendor the liability to the customer is extinguished and the amount of the deposit is released to revenue account; at this stage the effect of the transaction is that of cash sale.[6]

Tax Returns on Cash Basis Method

The use of cash basis for accounting or for statement preparation probably has substantial background from the fact that in many instances it is an acceptable basis of reporting taxable income. It is required that the method which clearly reflects income must be used, but this is not literally followed; there are many cases where the cash basis is accepted when it does not clearly reflect income. This expression has been interpreted as meaning "fairly and honestly" rather than "accurately or precisely."[7]

While considerable latitude has been allowed to the taxpayer, the government apparently could enforce an accrual basis in many cases where it does not do so. The acceptance of the cash basis is modified when inventories are required and also, for instance, when loan expenses have been incurred in connection with a long-term loan. The latter item must be

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[6] Paton and Littleton, op. cit., p. 60.

[7] Journal of Accountancy, Sept. 1953, p. 309.

spread, and the same position has been taken with respect to fire insurance premiums paid in advance, when applicable to a period in excess of one year. Allowance has also been made for depreciation but if a rigid position were taken by the Bureau of Internal Revenue on what accounting most clearly reflects income, many present taxpayers on a cash basis would be switched to an accrual basis. This probability may have been the cause of some of the delay in issuing any statement on cash basis financial statements on the part of the technical committees of the American Institute of Certified Public Accountants as they would not wish any announcement of theirs to interfere with practical procedures by taxpayers.

This tax problem is made more acute by the fact that a switch from a cash to an accrual method may result in pyramiding income in one period.

It is of interest, as well as significant and pertinent to this question, to advise of two very recent developments. We understand informally that the Bureau of Internal Revenue will not be influenced in determining its acceptance of the basis for tax accountability by any pronouncement made by the Institute on cash basis accounting. We can not accept this as it is probably any such statement which would weaken a taxpayer's claim that a cash basis was best for his use would be used against him. The second item is that a committee of the Institute has been appointed

to work out a reconciliation between generally accepted accounting principles and those followed for tax purposes.[8]

In the case of the typical individual tax return the use of the cash basis means the calculation of gross income in terms of cash receipts of salaries, wages, interest, rentals, etc., the corresponding accruals being neglected. The use of this basis, however, does not preclude the taking of a deduction for accrued depreciation, where this is appropriate, notwithstanding the fact that historically the practice of accruing depreciation was a rather late development in accrual accounting. Returns on a cash basis are not acceptable from business concerns where the inventory is a significant factor.

Pitfalls of Cash Basis for Employee Funds

Information on the size of the funds is not available at the present time. However, it is evident from various studies that their size and influence on the social and economic life of the United States is substantial. The congressional investigating committee estimated that in 1954, under private welfare and pension plans funded through insurance contracts and trusteed plans, 75 million individuals

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[8] Ibid., p. 310.

were covered to some extent, pension fund reserves were between $20 and $25 billion and contributions for the year were $6.8 billion. Recently, an excellent compilation by the State of New York Insurance Department indicated that under welfare and pension funds required to file annual reports with the Department in 1957, 2 million employees were covered, contributions during 1957 were $270 million and assets at the end of 1957 totaled $666 million.[9]

The propriety of the accounting for the funds is of utmost importance to all accountants because of the size and influence of such funds and because of the funds' financial reports tell the:

(1) Employees--how funds for their benefit are being accumulated and invested.

(2) Government--how tax-free funds are being used and managed.

(3) Employers--how their contributions are being used.

(4) Trustees--how results of their stewardship.

(5) Consultants and actuaries--some of the basis financial information necessary in their determination.

The fund financial information available to interested parties is generally limited to a statement of financial position showing the assets and liabilities at a certain date and a statement of financial operations showing the results of operations for a period of time. The statements may be prepared on either a cash or an accrual basis. There

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[9] Journal of Accountancy, Feb. 1960, p. 47.

seems to be considerable disagreement and uncertainty as to which basis is the proper one for funds.

It is the belief of some accountants that financial statements of welfare and pension funds prepared on a cash basis should generally not be used. As an illustration of how cash basis statements can be misleading let us look for a moment at the summarized statements of a typical fund which we shall call Fund A, prepared under both the cash and accrual basis of accounting for the calendar year 1958:

Statement of Financial Operations

	Cash basis	Accrual basis
Income:		
Contributions	$600,000.00	$630,000.00
Investment income	10,000.00	10,000.00
	$610,000.00	$640,000.00
Expenses:		
Insurance premiums	$500,000.00	$475,000.00
Administrative expenses	70,000.00	60,000.00
	$570,000.00	$535,000.00
Net increase in Funds	$ 40,000.00	$105,000.00
Difference	$65,000.00	

Statement of Financial Position

	Cash basis	Accrual basis
Cash	$ 40,000.00	$ 40,000.00
Investments	100,000.00	100,000.00
Contributions receivable		55,000.00
Investment income receivable		5,000.00
Premium fund receivable		25,000.00
	$140,000.00	$225,000.00
Less: Liab for Adm expenses		10,000.00
Net Assets	$140,000.00	$215,000.00
Difference	$75,000.00[10]	

As can be readily seen, the use of the cash basis of accounting in the above instance understates the results of operations for 1958 by $65,000.00 and understates the net assets by $75,000.00 mainly because of the failure to record contributions and premium refunds which were receivable at the year-end.

Differences in the two bases can be material, because of the nature of the transactions most frequently encountered by the funds, and it may thus be appropriate at this point to list these major transactions. They are:

(1) Contributions from employees

(2) Benefits granted to employees and their dependents

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[10] Ibid., p. 48.

(3) Investment of funds held for future employee and development benefits

(4) Administrative expenses.

Generally, contributions for welfare and pension benefits are based upon some measurement of employment such as hours worked or salary and, like wages and salary, represent incurred costs which are liabilities of the employer until paid by him. Ordinarily, under the applicable trust agreements, welfare and pension contributions are payable to a fund by a specified date. Nevertheless, like purchases payable thirty days after delivery, the event establishing liability has occured prior to payment date. Good accounting practice requires that the liability be recorded on the employer's books and the receivable recorded on the fund's books. In funds with only one employer it is a simple matter to determine the amount receivable, but in multi-employer funds often the administrative office can only estimate the contributions receivable.

CHAPTER III

ACCRUAL BASIS METHOD

Accrual Basis Defined

Generally, under an accrual basis method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deductions and the amount thereof can be determined with reasonable accuracy. The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally recognized and accepted income tax accounting principles and is consistently used by the taxpayer from year to year. For example, a taxpayer engaged in a manufacturing business may account for sales of his product when delivered or accepted, or while title to the goods passes to the customer, whether or not billed, depending upon the method regularly employed in keeping his books. Likewise, the extent to which indirect costs shall be included in computing cost of goods sold depends upon the method used by the taxpayer in treating such items in keeping his books.

And it appears that the alternate method of recording

charges currently at billing value has sufficient merit to warrant its adoption, certainly by those who are entering practice as principles or those whose practice has been reached a high level of development.

Principles of the Accrual Basis Method

In order that monthly figures may be of any value the expense accounting must be on as nearly complete an accrual basis as possible. If not, nearly every comparison of individual cost items must be adjusted because of the accrual situation and even the expense total may be seriously affected. For example, a given month in one year may contain five pay days, as compared to only four in the preceding year. It is evident that, if payroll accruals are not recognized in both cases, the comparison of cost items which reflect labor services will be useless. Similar recognition must be given to the accrual of such items as depreciation, insurance, taxes, utility bills, and other items. Inventories of supplies must be taken, or at least estimated, and in some cases maintenance reserves and other devices for recognizing the expense properly applicable to the month's operations must be used.

The basic idea under the accrual system is that the books shall immediately reflect obligations and expenses definitely incurred and income definitely earned regardless

of whether payment has been made or is due. Expenses incurred in operations for a particular year are properly accrued for that year although payment may not be due until the following year. The word "accrue" does not mean that the item is due in the sense of being then payable. The accrual system wholly disregards due dates.

On the accrual basis method, income must be reported in the year when the right to receive it becomes fixed. It makes no difference that the income may actually be collected and received in a later year.

That is the prime difference between the accrual and cash methods of accounting: It is the right to receive income, as distinguished from actual receipt, which determines taxability. In general, the accrual basis taxpayer reports his income when he earns it, and not when he receives it.

The court cases lay down three basic rules as to when the right to receive income becomes fixed and accruable for inclusion in a taxpayer's return. They are:

(1) The taxpayer must have a valid, unconditional and enforceable right to receive the income within the taxable period.

(2) The amount due must be determinable or susceptible of reasonable estimate.

(3) There must be a reasonable expectancy that the amount due will be paid and collected in due course.[11]

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[11] Casey, op. cit., p. 42.

On the negative side, these rules mean that a taxpayer does not have to take into income contingent claims, contested claims, or uncolletible claims.

Accrual Policy of Depreciation

(A) Character of Accrual Policy:

The general procedure in accruing depreciation consists of estimating the service life of the unit under consideration, and spreading the cost, adjusted cost, or other basis of asset value over such service life in accordance with some systematic method of apportionment by means of charges to operating accounts and credits to a reserve or allowance account. Later, when the unit is retired from service for whatever cause, the asset account is credited with the appropriate amount, the allowance is charged with the amount applicable, proper account is taken of net sale or salvage value, if any, and any necessary adjustment is made through income or surplus accounts. The main features of the system can be emphasized with a simple illustration.

A machine costs $1,100, is expected to last for five years, and it is estimated that the net salvage value will be $100. The depreciation base, cost less net salvage, is thus $1,000. The entries for the first year's depreciation (using the straight-line method of apportionment) can be summarized as follows:

Operating accounts	200	
Allowance for depreciation		200

Similar entries would be made for each year the machine is continued in service. If the unit were retired at the end of the fourth year, after the allowance for that year had been set up, the net salvage value being $125, the transaction would be recorded as follows:

Allowance for depreciation	800	
Loss on retirement of machine	175	
Cash	125	
Equipment control (machine)		1,100

If the operating accounts for the fourth year had not been closed when the machine were retired there would be something to be said for an inslusion therein of one-fourth of the loss of $175.

(B) Effects of Accrual on Fixed and Working Assets:

The effect of the policy of accruing depreciation upon the reported financial status of an enterprise can be indicated by consideration of a simple example:

At the beginning of business, the accounts of the X Company stand as follows:

Current assets	$ 50,000	Current liabilities	$ 25,000
Fixed assets	75,000	Capital stock	100,000
	$125,000		$125,000

During the first year revenues amount to $180,000; expenses

and all charges, including depreciation of $7,500, total $167,000. No plant assets have been retired and no additional units required. Current liabilities are increased in the amount of $5,000. No dividends have been paid. After all adjusting and closing entries the company's accounts show balances as follows:

Current assets	$75,000	Current liab.	$ 30,000
Fixed assets (cost)	75,000	Capital stock	100,000
Allow. for depreciation(Cr.)	7,500	Surplus	12,500
	$142,500		$142,500

At this point the funds covering expired plant cost are included in current assets, as shown by the following:

Composition of current assets:

Amount at beginning of period	$50,000
Amount resulting from increase in current liab.	5,000
Funds representing converted plant cost	7,500
Funds representing net profits	12,500
	$75,000

If a current ratio of 2:1 is considered necessary this means that current assets must be retained in the amount of $60,000, and that the balance of $15,000--if available in cash--can be expanded for any proper corporate purpose. This balance may be considered to be made up proportionately of funds representing converted plant and profit funds.

The significance of the depreciation accrual on

financial status can also be seen by considering the effect of the consistant failure to recognize accrued depreciation on the part, for example, of the typical manufacturing establishment.[12]

(C) Effects of Depreciation Accrual on Income and Dividends:

The most significant aspect of the accruing of a depreciation reserve can be traced through the consideration of the effect upon income accounting and the dividend policy. If in a given case the gross revenues total $100,000 and all expenses exclusive of depreciation amount to $80,000, the inclusion in expense of a depreciation accrual of $10,000 results in a net income figure of $10,000, whereas were there no recognition of depreciation, the stated net would be $20,000. This reduction of the yardstick of net income below the figure which would appear were depreciation neglected tends to induce a more conservative policy with respect to dividend appropriations, and thus funds tend to be retained in the business which might otherwise be disbursed as income, with resulting impairment of capital. An accumulation of "surplus" in lieu of the depreciation allowance, it is true, would accomplish the same result, but surplus, which represents a legal basis for dividend appropriations, is not a proper caption to apply to estimated depreciation, and the use of such a caption would not only

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[12] W. A. Paton, Accountants' Handbook, 3rd ed., 1948, p. 743.

obscure the real situation but would not encourage the accumulation of a proper amount or its permanent retention.

(D) Effects of Accrual Where Earnings are Insufficient:

Under the accrual or reserve policy, proper allowances for depreciation should be made even where revenues are insufficient to cover such allowances. Depreciation expresses the expiration of the service capacity of depreciable fixed assets. In many instances revenues are insufficient to cover total expenses, quite aside from net profit. In such situations, however, to ignore depreciation would be just as unreasonable as to neglect to account for any other cost element; if asset values can reasonably be said to have expired the fact that such values are not recouped is no warrant for a failure to recognize the expiration. "Unearned" depreciation is, like all depreciation, the estimated loss in use value of fixed assets. But if the depreciation, in whole or in part, is not covered by revenues, the building up of current assets to take the place of the estimated decline in value of fixed assets naturally does not occur; instead the depreciation charge, in whole or in part, contributes to the deficit resulting from the inadequacy of earnings. It should be emphasized, however, that the depreciation charge has the same proportionate relation to the deficit in such a case as any other operating cost, and cannot reasonably be said to be peculiarly responsible.

In a special report dealing with depreciation the Interstate Commerce Commission refers to this point substantially as follows:

The accruing of depreciation charges on the books does not necessarily mean that corresponding accounts are collected from the public served. If, after depreciation charges have been accrued, net earnings are insufficient for the payment of a reasonable return, then the burden of such charges is borne in whole or in part by investors. Indeed, depreciation charges may not involve the diversion of actual funds from either patrons or investors, for where a company is operating at a deficit they will serve only to increase the extent of the recorded deficiency.[13]

The primary object of the periodic depreciation allowance is to preserve the dollar investment, but this is not accomplished unless the depreciation is actually earned. If, for example, the accrued depreciation for the first period is $18,000 and the income statement, after all charges, shows a loss of $9,000, it is evident that the depreciation charge has been but half earned. However, this does not necessarily mean that the depreciation is the last cost earned. It might be assumed that expenses represented by current cash disbursements are first earned, and that the charge representing accruing depreciation is earned

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[13] Ibid., p. 743.

only if the balance of revenue is sufficient to cover it. This theory appears to belittle the importance of depreciation. If it is true that fixed assets are prepaid expenses it may be said that these expenditures precede current expenditures, since they were incurred perhaps years in advance. A possible approach, where revenue is insufficient to cover all expense, is to regard the unearned part of expense as related, on some reasonable basis, to all the various expenses.

Year Income Is Taxed When One Uses the Accrual Method

(A) Include Income This Year:

1. If the events occur determining one's right to receive a fixed amount.
2. If the events occur determining one's right to receive a readily ascertainable amount. It is sufficient if only a computation remains based on ascertained factors.
3. When one's right to receive an amount is fixed, even though there exists some slight contingency, for example, one is taxed when one actually receives compensation, profits, etc., from a fund; even if later one agreed that it was overpaid in error and that it may be deducted from future payments due to one from the fund. Compensation actually received under an ultra vires plan prior to its cancellation.
4. If one actually receives earnings under a claim of right and without restriction as to their disposition, even

though they may be subjected to dispute and returnable.

5. When one's right to receive an amount is readily ascertainable, even though it is subject to litigation or contest, for example, proceeds received from insurance on account of fire, theft, or other loss. But watch the exception to this if gain is not recognized under involuntary conversion rules. If the principal amount is agreed upon and only a small sum is being disputed.

(B) Include Income Later Year:

1. If there is a substantial contingency as to legal liability or collectibility or an inability to value one's receipt. For example, one defers the following income:

   Receipts that are unavailable or which have no readily ascertainable market value.

   Payment received under an option to purchase. It is to be applied against purchase price when the option is exercised and to be retained upon failure to exercise it.

   A settlement subject to confirmation by a court or third party.

   Earnings subjected to foreign monetary or exchange restrictions.

2. If the earnings are held in escrow and title to them may only be acquired upon the happening of future events. For example, one defers earnings impounded by a court subject its final decision.

3. If the right to the earnings is contested or in litigation, for example:

   Amount disputed and undetermined. A judgment does not terminate litigation if appealed.

   Advances for service or goods. The following cases allowed postponement in reporting income:

   Sum received from a tenant soley as security for one's full performance under the lease.

   Sum received from a tenant and held interest for him as long as one complies with the lease, whether the statute or agreement makes it a trust fund.

   Sum received from a prospective tenant prior to execution of the lease.

4. Publishers of periodicals may elect to prorate prepaid subscriptions if they also prorate cost of soliciting them.

5. Sum received by a wholesaler or distributor in advance, for merchandise "if and when" in stock. This is income in the year of the delivery of the merchandise, not when the deposit is made.[14]

6. Subsequent insolvency of lessee did not prevent taxpayer from accruing rental as income, since in the period of the accrual taxpayer had a fixed right to receive a reasonably ascertainable amount of rental income. However,

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[14] J. K. Lasser, Standard Handbook for Accountants, McGraw-Hill Book Co., New York, 1956, p. 2,288.

accruals made on account of rent when the receiver of the lessee was in possession of the rental property were improper in the taxable years, which were before the liability of the receiver had become fixed. Likewise, interest on bank funds impounded by receiver was not accrued income in the taxable years, since at that time it could not be determined whether any interest would eventually be paid, or, if paid, the amount thereof. The interest in question was not income until received.

7. Accrual basis taxpayer engaged in a general finance business which purchased notes at below face value is not required to report the difference between face value of the notes and the purchase price as income in the year of purchase. Its method of accruing the income over the life of the notes as the amounts become due in 1954 and 1955, for example, as ordinary income is approved.

Year One's Deduction Is Taken When One Uses the Accrual Method

(A) Deduct This Year:

1. If the events occur fixing the amount and the loss.
2. If the events occur fixing the amount and the liability for the cost, one may deduct.

   Even though the expense is not subsequently paid. It is later refunded upon cancellation of the contract.

Even though the time of payment is extended.

3. If the events occur fixing approximately ascertainable amount as liability for the cost. For example, one has a deduction if the amount may be reasonably estimated and the precise amount determined later.
   If outstanding liabilities for freight charges on goods shipped may be only substantially accurate.
   If one may admit liability, makes an offer in compromise, and accrue a reasonable estimate of the amount on one's books.

(B) Deduct Later Year:

1. If one disputes liability for a cost, note this:
   The mere commencement of suit against one is insufficient to get a deduction if one denies liability.
   One offers of settlement or deposit in court as compromise is not sufficient to get a deduction until it is accepted.
   One's appeal from the judgment against one continues the the contest and denies one a deduction.
2. If one's liability is contingent or dependent upon the happening of future events, deduction is postponed.
   That includes provisions for reserves for cash discounts, anticipated losses, or repairs, etc. One may deduct costs only when the liability is fixed or becomes absolute. But one case holds one can deduct where one can reasonably estimate the cost.

3. The following types of prepaid expenses are prorated and not deducted this year:

   Interest in advance, over the life of the loan.

   Insurance premiums in advance, over the term the premium is paid for.

   Bonus to obtain a lease, over the term of the lease.

   Broker's commissions and legal fees to secure a lease, over the terms of the lease.

   Broker's commissions and legal fees to secure a mortgage, over the life of the mortgage.

   Broker's commissions and legal fees to secure a loan, over the life of the loan.[15]

4. Salesmen's commissions have been held to be deductible when the orders are accepted, even though the orders are not filled until a later year, where the income is reported as having accrued at the time when the orders are accepted. However, where an accrual basis taxpayer did not report income until the orders were shipped and billed, it was not allowed to accrue and deduct commissions in the year in which the orders were accepted.

Special Item: Unpaid Interest and Other Expenses

Ordinarily there is nothing to prevent the deduction of interest and business expenses to related interests, if

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[15] Ibid.

the payment is bona fide and meets the usual requirements for deduction. However, there may be a bar to the deduction if the payer is on the accrual basis and the related payee is on the cash basis. If it were not for a special statutory provision, the payer could deduct an accrued obligation which, because of the relationship, he might never be called upon to pay. And, because the cash basis creditor would owe a tax on the unpaid amount, these manipulations would be carried on at the expense of the Treasury Department. To close this loophole, Code Sec. 267 (a) prohibits an accrual basis taxpayer from deducting expenses, including compensation for services, incurred in trade or business or in earning income, or accrued interest:

(1) If within the taxpayer's taxable year and two and one-half months after the close thereof such expenses or interest is not paid; and

(2) If within the taxpayer's taxable year and two and one-half months after the close thereof the amount thereof is not includible in the gross income, either by actual or constructive receipt, of the person to whom the payment is to be made; and

(3) If, by reason of the method of accounting of theperson to whom the payment is to be made, the amount thereof is not, unless paid, includible in the gross income of such person for the taxable year in which or with which the taxable year of the taxpayer ends; and

(4) If, at the close of the taxable year of the taxpayer or at any time within two and one-half months thereafter, both the taxpayer and the person to whom the payment is to be made are persons between whom losses should be disallowed under Sec. 267 (a) (1).[16]

It is important to note that, if payment is not made within the prescribed period, deduction will be disallowed, not only for the taxable year, but also for any subsequent year in which the debt actually may be paid.

All four of these conditions must be present; if any one is not shown, the deduction is not precluded by Code Sec. 267 (a) (2).

The first three conditions set out above can be restated affirmatively, incorporating the rules which appear to have been developed to date by the courts for their application. So stated, the deduction is permissible under Sec. 267 (a) (2):

(A) If within the taxpayer's taxable year and two and one-half months after the close thereof the amount accrued is "actually" paid by cash or negotiable paper having a determinable market value, or

(B) If within the taxpayer's taxable year and two and one-half months after the close thereof the amount accrued is includible in the gross income of the payee regardless of

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[16] Commerce Clearing House, Standard Federal Tax Reporter, Rule 2,251.021.

whether he actually or only constructively received it within that period.[17]

It should be noted that in satisfying either of the two conditions it is possible for the deduction to be taken in one year and the income returned by a cash basis employee in the subsequent year. The circumstances under which accrued compensation might be disallowed can be best illustrated by a series of examples, in which the following assumptions are made, unless otherwise stated: The employer is Corporation X, which is on an accrual and calendar year basis, and the employee is A, who is on a cash and calendar year basis. The Corporation has accrued but not paid at the end of 1959 $600.00 in salary and $300.00 in interest due to A, amounts which would be deductible expenses except for the provisions of Code Sec. 267 (a) (2) applicable, unless some other condition is not satisfied.

Example (1): X corporation accrues both the $600 salary and $300 interest due to A at the end of 1959. It makes a cash payment March 15, 1960, in full. May X corporation deduct the $900 in its return for 1959?

Yes. The accrual amounts were paid within the first 2 1/2 months following the end of the taxable year for which the deduction is taken, and condition (A) is satisfied. The deduction is allowable even though A, being on the cash basis, does not include the $900 in his income until filing his

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17 Ibid.

return for the next taxable year, that being the year in which he actually received the cash or its equivalent.

Example (2): X corporation gives A, during 1959 or within 2 1/2 months after the end of the year, its time or demand note having a face value equal to the amounts accrued at the end of 1959. The note is given by X corporation and accepted by A as payment of the $900. Are the accruals deductible by X corporation for 1959?

Yes. The decisions to date have recognized such notes as "actual" payment which meets condition (A) above.

Example (3): In addition to accruing the $900 on its books at the end of 1959, X corporation has also credited the amount to A in such a manner that it was subject to his unqualified demand before the end of the year. Accordingly, the $900 is constructively received by A and is includible in his income for 1959. May X corporation deduct the unpaid $900?

Yes. Here, condition (B) has been met.

Example (4): X corporation accrues the unpaid items, as in example (3), but does not enter the credit to A until January 15, 1960, as of which time it is constructible received by A. May X corporation deduct the $900 in its return for 1959?

Yes. A constructively received amount within the two and one-half months period following the close of X corporation's taxable year and, therefore, condition (B) has been

met.

Example (5): Both X corporation and A are on the accrual and calendar year basis. Corporation X accrues the unpaid $900.00 at the end of 1959, but does not credit or pay it to A within the first two and one-half months of 1960. May X corporation deduct the $900.00 for 1959?

Yes. Since A would be required to accrue the $900 and include it in his income for 1959, and the corporation's deduction is taken for a year which ends with or within 1959, condition (B) is met and the deduction is allowable.

Example (6): Corporation X accrues the unpaid $900.00 at the end of 1959, and makes payment to A, who is on the cash basis, on June 1, 1960. There has been no note executed and no credit entered to A's account in the meantime. May Corporation X deduct the $900.00 for either 1959 or 1960?

No. The disallowance for 1959 is in accordance with the examples above, and neither condition (A) nor (B) is met. Nor is the $900.00 accruable for 1960, since it was not incurred in that year, nor is it an "expense" of that year. An accrued item must be deducted for the year in which it is properly accruable, or not at all. The $900 was properly accruable for 1959--this fact is not changed by the statutory provisions which, it has been noted, are effective with respect to items which are otherwise accruable and deductible.

Example (7): Corporation X is on an accrual and fiscal year

basis, with a taxable year ending September 30, 1959. During September it accrued a bonus which was actually paid to A on December 28, 1959 (more than two and one-half months after the close of corporation X's fiscal year, but within A's taxable year). May corporation X deduct the bonus in its return for the fiscal year ending September 30, 1959?

Probably. The condition described in Code Sec. 267 (a) (2) (B) would not seem to be met. In order for the deduction to be disallowed, the conditions described in Code Sec. 267 (a) (2) (A), (B), and (C) must all be met. The reason that the amount is not includible in A's taxable income is his accounting period and not his accounting method mentioned in subparagraph (B). The primary purpose of Sec. 267 is to close the tax-saving loophole which, in other circumstances, would make it possible for one taxpayer to take a deduction while the corresponding income of a related taxpayer would not be reported until a later year.[18]

Advantage of the Accrual Basis Method

The principal reason why the accrual method is used by many businesses of any size is that it reflects the true income of the business more accurately.

This follows from the basic principle that the income earned during a given period is "matched" by the related costs

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[18] Ibid.

and expenses incurred in earning such income. The accrual basis method tends to spread income and expenses more evenly over the accounting periods.

Some of the advantages of the accrual method of recording charges are:

(1) the progress of the engagement may be readily measured by comparison of charges with estimates prepared in advance;

(2) comparison of fees earned from month to month and year to year, indicating trends in the progress of the practice, are available;

(3) in seeking credit the accumulated value of unbilled charges, a definite asset, appears in the records; and

(4) no other method furnishes such accurate information regarding income and profits.

Probably all practitioners use time reports on which the hours within the reporting period are accounted for by each member of the organization. The form of the time report has no particular significance for the purposes of this section except that total chargable hours and total reimbursable expenses should be shown. The time reports constitute the source of origin for all charges to clients. Work-in-process sheets are maintained for each client, and the charges shown on the time reports are posted to the work-in-process sheets each reporting period.

Before posting the time reports to the individual work-in-process sheets, the total of chargeable hours shown

on each report is priced at the prevailing per diem rate and the amount of expenses shown on the report is added to the value of the time, so that each report has an aggregate billing value which will be used at the end of the month in proving the monthly charges. The hours shown on each report are then posted to the work-in-process sheets. A specimen form of the work-in-process sheet appears as Figure 1 on the following page, which also shows an example of the use of the sheet. The sheets which are lithographed, 11 by 14 inches, are filed in a special holder. The space provided at the top of the sheet is used for the name of the client and the file number under which material pertaining to that client might be found. The space provided is sufficient to state the basis of ultimate billing if an irregular basis has been agreed upon. Policy discounts to non-profit organizations are typical. Generally, however, each principal is responsible for billing clients subject to his supervision and such a reminder is not essential.

In posting the sheet Figure 1, it is assumed that time reports are prepared on the fifteenth and last day of the month. When the reports for the last period of the month have been posted, the hours shown on the work-in-process sheet are totaled; the value of the service is computed by applying the indicated per diem rate; and the aggregate of the charges is then accumulated in the column provided for that purpose.[19]

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[19] Ibid., p. 1.56.

Jackson Machine Company

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File Number

Period Ended		$15.00		$10.00		$7.50		$5.00		$4.00		$200		Expenses			Total Charges		Cumulative (Work-in-process)	
		Name	Hrs	Name	Hrs	Name	Hrs	Name	Hrs	Name	Hrs	Name	Hrs	Name	Amount					
															Forward				250	00
								YEAR ENDED June 30, 1952												
1	15	Smith	3	Allen	40			Mock	40					Allen	50	00				
								Jones	30					Mock	40	00				
														Jones	30	00				
1	31	Smith	15	Allen	30			Mock	20											
		$270	18	$700	70			$450	90						120	00	1540	00	1800	00
2	15	Smith	15	Allen	4							Ruth	10							
												BEA	15	Tel	17	50				
2	28	Smith	3									Ruth	4							
		$270	18	$40	4							$87	29		17	50	414	50	2214	50
												Final Billing					(2100	00)		
												Final Adjustment					(114	50)		
								YEAR ENDED June 30, 1953												
7	15			Young	40									Young	40	00				
7	31	Smith	2	Young	15							Kay	4	Young	10	00				
		$30	2	$550	55							$12	4		50	00	642	00	642	00
												Interim Billing					(750	00)	(108	00)
12	15	Smith	5	Allen	20			PrKr	10					STWT	17	50				
		$75	5	$200				$50									342	50	234	50
1	15			Allen	15	STWT	30	Mock	40					Allen	12	50				
														Mock	37	50				
														STWT	25	00				
1	31	Smith	5	Allen	10	STWT	30	Mock	20					Allen	27	00				
														STWT	25	00				
														Mock	10	00				
		$75	5	$250	25	$450	60	$300	60						137	00	1212	50	1447	00
2	15	Smith	6	Allen	15									Tel	12	50				
2	28	Smith	1	Allen	2							Kay	20							
												Lil	10							
		$105	7	$170	17							$90	30		12	50	337	50	1824	50
												Final Billing					(2100	00)		
												Final Adjustment					(225	50)		

FIGURE 1 WORK-IN-PROCESS SHEET

Disadvantages of the Accrual Basis Method

On the other hand, the accrual basis taxpayer has much less leeway than the cash basis taxpayer in deferring the receipt of income items and accelerating the deduction of expenses for the purpose of minimizing taxable income in any given year. This is because the accrual basis taxpayer has to report income and deductions in the year that they are accrued or incurred.

Nevertheless, within narrow limits, one can postpone income by shipping and billing as little as possible toward the end of the year. One can accelerate deductions by advancing repairs and advertising expenditures within the desired period, purchasing supplies, securing bills for professional services performed before the end of the year, etc.

CHAPTER IV

APPLICATIONS OF THE METHODS IN THE MANUFACTURING BUSINESS

This chapter is an analysis of the answers obtained from questionnaires to manufacturing businesses and professional businessmen.

Replies were obtained from seventeen businesses using the accrual method of accounting and four businesses using the cash basis.

The aim of this chapter is to point out significant items in the adoption of a method of accounting and to some particular items which require special treatment on either the accrual or cash basis.

(1) Which method of accounting do you use to determine the revenues and expenditures for your business?

Cash basis method 4

Accrual basis method 17

Other method (name of it) none

All of those businesses on accrual basis method are manufacturing businesses.

Three of those on the cash basis method are professional firms, such as doctors and attorneys, and the other one is a furniture company. This furniture company changed its method of accounting from accrual basis method to the cash basis method recently because of tax advantages.

(2) If you have used that method more than five years consistently, what is the main reason of using that method?

It results in less tax than other methods __none__

It is an easier method to compute income and expenses than other methods __1__

Other reason (briefly explain) __19__

Regardless of the method they are using, nearly all of them answered in the other reason column. Their explanation varies from one to another, but the purposes of using a method are the same. For example, the answers given are:

"More accurate with respect to period of time consumed."

"The accrual method provides for matching of income and expenses; gives the most comprehensive and complete picture of operations and of financial position."

"A truer reflection of net earnings."

"Most accurate presentation of operating results for accounting period."

From the answers shown above it is clear that the purpose of using a method consistently is greater accuracy in representing their operational revenues and expenses.

(3) If you are planning to change to another method soon, what is the disadvantage of the method which you have used?

It is too complicated in recording transactions __None__

It results in more tax than other methods None

Other reason (briefly explain) None

To this question, all respondents answered that they are not planning a change in their methods, except the furniture company who just changed their method of accounting from the accrual basis to the cash basis because of the tax advantages.

(4) Which method of accounting did you use before you changed to the method you use now?

Cash basis method 2

Accrual basis method 19

Other method (name of it) none

One of those who answered the cash basis method column is a professional businessman who has been using cash basis for the method of accounting since he started his business.

The other one is a shoe manufacturer who now is using accrual method.

One of those nineteen who answered the accrual method column is a professional business now using cash basis method for his business.

(5) If you have changed from another method to the one which you use now, when was it?

Before 1954 2

After 1954 1

Two of those who changed their method from one to another, changed their method before 1954. That means that the revised 1954 Revenue Code did not affect the adoption of the method of accounting to any great extent.

The one who changed after 1954 is the furniture company who changed their method recently.

(6) If you have changed from another method to the one which you use now, who initiated the change?

You (taxpayer) 3

The Commissioner none

The Internal Revenue Code states that if the accounting method which is used by a taxpayer "does not clearly reflect income," then the Commissioner can prescribe a method. From the answers received it appears that the change of methods is usually made voluntarily by the taxpayers.

(7) Did your taxable year influence you to adopt the method of accounting you use now?

Yes 2

No 10

Both of those answerin yes are manufacturers. They are using accrual method and have used that method since their corporation organization. The manufacturers are an aircraft corporation and a milling company.

(8) Do you expect the income tax rates to go up or down in the foreseeable future?

Will go up 6

Will go down 1

No change 3

To this question, among those who answered, six manufacturing businesses expressed that they feel that the current income tax rate will go up in the foreseeable future.

Three of those who answered expressed that they just did not know, but think there will be no change in the foreseeable future.

The one who answered the "Will go down" column is a manufacturer and that is the one who has changed his method of accounting from cash to accrual method before 1954. It is a shoe manufacturer.

(9) If you are on an accrual basis and sell merchandise on credit, and if a debtor were in bankruptcy at the close of that year, what would you do about that transaction?

Will include that in the income of that year 12

Will not include that in the income of that year 2

The manufacturing businesses that answered that they would include that in the income of that year added that the provision for bad account would be made and bad debt would be written off.

Those who answered that they will not include that in the income of that year are a mining company and a candy corporation.

The Internal Revenue ruling on this matter found in the Standard Federal Tax Reporter is as follows:[20]

Where merchandise was sold by taxpayer in this year, and the debtor was in bankruptcy at the close of the same year, such facts do not warrant the exclusion from gross income of this year, on an accrual basis, of the amounts of such sales. If such accounts become uncollectible the question is one of deduction under the applicable statute.

(10) If payments were received in advance, and were returnable upon the happening of some specified condition, would you include that income in this year's income or in the income of a later year?

This year's 1

Later year's 9

The one who said that it will be included in this year's income is an electric appliance manufacturer.

Internal Revenue Service rulings on this are as follows:

It will reduce sales by the amount of credit given

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[20] Standard Federal Tax Reporter, 1960 Vol. 1, Commerce Clering House, Inc., Reg. #1.61-3 *652.073.

for the merchandise which was returned to taxpayer. If the merchandise was re-sold during the taxable year, the re-sale price would be included in sales; if not sold, the merchandise would be reflected in closing inventory.

In taxable years beginning after 1957, accrual basis publishers of newspapers, magazines, or other periodicals may elect to spread prepaid subscription income over the taxable years during which the liability to furnish or deliver the periodical exists. A publisher has prepaid subscription income to which this election may be applied if amounts are received which are directly attributable to a liability which extends beyond the close of the taxable year in which the amounts are received. The election may be made at any time with the Commissioner's consent or without his consent in the first year after 1957 in which prepaid income is received.

(11) If your method of accounting is the cash basis method, how would your business treat the following case?

Insurance premiums paid in advance for more than one year.

Deduct the total amount in the year you made payment __3__

Deduct the total amount over the period of insurance coverage __1__

Three of those who answered this question said that they deduct the total amount in the year they made payment.

And the one who said that the total amount will be deducted over the period of insurance coverage is a shoe manufacturer who now uses the accrual method, but it is the business who used the cash method of accounting before the company changed to the accrual method.

The Internal Revenue position on this is as follows: Where insurance premiums are paid in advance or for more than one year, the Internal Revenue Service position is that only a pro-rata part of the premium is deductible for each year, on either the cash or the accrual basis. The Eight Circuit Court, however, allowed a cash-basis taxpayer to deduct the premiums in the year paid, where that had been the taxpayer's long-established practice, thereby, putting itself at odds with the First Circuit Court.[22]

(12) Do you deduct from your current year's income the estimated costs and expenses attributable to such income although these may be incurred in future years?

Yes 6

No 9

Six businesses answered that they will deduct such costs and expenses from their current year's income. Five of those above six are manufacturing businesses and the other one is a professional business.

Nine of those who answered said that they will not

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[22] Ibid., p. 312, paragraph 705.

deduct such estimated costs and expenses from current year's income. Seven of those above none are manufacturing businesses and the remaining two are professional businesses.

(13) If you have advertising expenses incurred or paid in advance although the benefits of them may not be reaped until some future period, when would you deduct the expense?

This year 15

Later year 4

Prorate over the years 1

Fifteen businesses said that they deduct such advertising expenses in this year. Twelve of them are manufacturers and three of them are professional businesses.

Four businesses said that they deduct such advertising expenses in a later year and one manufacturer siad that such expenses will be prorated over the years.

According to the Internal Revenue Service, to be deductible, advertising expenses must be reasonable in amount and have a reasonable relation to the business. They may be institutional in nature, that is, to develop goodwill rather than to obtain immediate sales, although the cost of buying goodwill is a capital expenditure. The cost of advertising is deductible when paid or incurred, even though the advertising program extends for several years or is expected to result in benefits extending over a period

of years. The Tax Court and the Commissioner require that the cost of catalogs which are not replaced annually be amortized over the expected life of the catalog.[23]

(14) When would you deduct the following expenses?

You made payments for advance rental and salaries to employees for services to be rendered in the next year.

Deduct the amount in this year __2__

Deduct the amount in the later year __3__

Two of those five who answered this question said that they deduct the amount in this year when they made payment. They are on the cash basis. Two manufacturers who are on the accrual basis answered that they deduct that amount in the later year.

The furniture company which is using the cash basis method said it would be deducted in the later year.

According to the Internal Revenue Service, the general rule is that prepaid expenses such as rentals, salaries, etc., and liabilities (with the exception of prepaid taxes and interest in the case of cash basis taxpayer) cannot be deducted simply because they have been paid. They must be deducted in the year in which the related income is earned. Of course, if any part of the expense

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[23] 1959 U. S. Master Tax Guide, Commerce Clearing House, Inc., p. 307, paragraph 694 B.

for rent, salary, etc., is for the year of payment, then an aliquot portion of the prepaid expense is currently deductible.[24]

(15) Which method of accounting would you adopt to determine revenues and expenditures of your business in the case of your business selling merchandise on the installment plan?

Cash basis method __1__

Accrual basis method __1__

Other method (name of it) __none__

This question is a special question which was asked of only two manufacturers. They are a watch manufacturer and a furniture company. The watch manufacturer said that the accrual basis method would be adopted and the furniture company said that the cash basis method would be adopted.

According to the Internal Revenue Service a taxpayer is usually taxable on the entire gain from the sale of property at the time the sale is executed, even though he may not receive the payments until subsequent years. An accrual basis taxpayer, of course, must include the amount of the future installments which the purchaser is obliged to pay. A cash basis taxpayer must include the fair market value of the note, or other negotiable instruments, which he

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[24] Ibid., p. 165, paragraph 344.

receives as security. But the seller may, if he desires, elect to report the gain in installments, in which case a portion of the gain will be taxable during each year in which payment is received. By electing the installment method, the taxpayer can be assured that the tax for the year of sale will not cut too deeply into his cash resources.[25]

(16) During current year's business operation, a certain amount of expense has occurred and you issued a note for the payment. The note was cleared by you in the next year. When would you deduct this business expense?

This year __1__

Next year __2__

This question was asked only of cash basis taxpayers. Two answered that they would deduct such expense in the next year when the note was cleared.

One person still said that he deducts such expense in this year when he issued the note. According to present tax regulations that expense should be deducted in the next year when the note was cleared by the issuer.

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[25] Standard Federal Tax Reporter, op. cit., *263.04.

CHAPTER V

CHANGE OF ACCOUNTING METHOD

Except as otherwise expressly provided in chapter one of the Internal Revenue Code of 1954, and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item, consent must be secured whether or not a taxpayer regards the method from which he desires to change to be proper. Thus, a taxpayer may not compute his taxable income under a method of accounting different from that previously used by him unless such consent is secured.[26]

This chapter deals mostly with the change from the cash method to the accrual method, or vice versa.

In order to secure the Commissioner's consent to a change of a taxpayer's method of accounting, the taxpayer must file an application by letter with the Commissioner of Internal Revenue, Washington 25, D. C., within 90 days after the beginning of the taxable year in which it is desired to make the change.

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[26] Federal Taxes, 1961 Vol. 1, #6053, *1.446-1-(e).

The application shall be accompanied by a statement specifying the nature of the taxpayer's business, his present method of accounting, the method to which he desires to change, the taxable year in which the change is to be effected, the classes of items which would be treated differently under the new method, and all amounts which would be duplicated or omitted as a result of the proposed change. The Commissioner may require such other information as may be necessary in order to determine whether the proposed change will be permitted. Permission to change a taxpayer's method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms, conditions, and adjustments under which the change will be effected.

Change Without Consent

The Code does not prohibit a change of accounting method without the consent of the Commissioner. But it does require a taxpayer to obtain permission to change the method of computing income.

Where a taxpayer has changed his accounting method without consent, the Commissioner may require the taxpayer to file the returns under his old method. On the other hand, he may accept the returns on the new basis, and require the taxpayer to accept its consequences even if the taxpayer should prefer to revert to the old method. But, where the

taxpayer changed his accounting method, and not the basis of his tax returns, the Fifth Circuit Court has held that the Commissioner may not require the returns to be filed on the new basis, despite the Code requirement that the book method must be used in computing income.

The Commissioner's direction in refusing to accept returns on a changed basis is limited, however. He may not reject returns after he tacitly consented to the change by auditing and accepting the returns as filed over a period of years. The Tax Court has found implied consent where only the basis of the return was changed but not the accounting method.[27]

Change of Wrong Method

A taxpayer using an improper accounting method faces a dilemma. The Code prohibits the computation of income under a method which does not clearly reflect income. Yet, even if he considers his method of accounting and reporting improper, he may not change to a proper method without the Commissioner's consent. If he does not apply for permission to change, the Commissioner will require his to change.

The dilemma is created by the fact that attempting to correct an accounting method may involve a greater tax

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[27] Ibid., #6071.

burden than awaiting the Commissioner's demand for correction. Under the 1939 Code, the courts generally held that taxpayers who voluntarily changed their accounting method had to include all necessary adjustments in the year of the change. But where the Commissioner required a change because the taxpayer's method was improper, the taxpayer was permitted to escape making adjustments. The 1954 Code, modifying the effects of a change, eliminated the advantage of awaiting action by the Commissioner. The advantage was partially restored, however, by the Technical Amendments Act of 1958 which required adjustments applicable to pre-1954 taxable years only where the change is voluntary.

Changes Required by the Commissioner

Where the taxpayer's method of accounting does not clearly reflect his income, the Commissioner has wide discretion in his choice of a method of computing the taxpayer's income. It is not limited by his acceptance of a taxpayer's returns in prior years. But he may not require a change from one proper method to one he considers better, nor from one improper method to another improper method.

Commissioner's Power to Require Change

The taxpayer's use of an improper method for many years does not prevent the Commissioner from requiring a

change. But a deficiency assessment will not be approved where the method employed by the Commissioner in his computations is improper.[28]

Adjustments Required by Change in Method of Accounting

A change in a taxpayer's accounting method will generally require an adjustment of his income in the year the change is made to avoid duplication or omission of items of income or deductions. If the net amount of the adjustments attributable to 1954 Code years is an increase in taxable income of not more than $3,000, or is any decrease, the entire amount of the adjustment is made in the year of the change.

Limitations on Tax

If the increase in income attributable to 1954 Code years exceeds $3,000, Sec. 481 provides for a limitation on the increase in tax. The adjustment may be made by (1) a three-year allocation method, (2) an allocation under the new method of accounting, or (3) any other method agreed upon by the taxpayer and the Commissioner.

(1) Three-year allocation method.

If the taxpayer used his old method for the two taxable years preceding the year of change, the tax for the year of the change is reduced to the amount that would

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[28] Ibid., #6077.

have been paid if one third of the increase in income had been received in the year of the change and one third in each of the two preceding years.

(2) Allocation under new method of accounting.

If the taxpayer can establish his taxable income for one or more years consecutively preceding the year of the change, he may reduce his tax to the amount that would have been paid if the new method had been used during those years, except that any remaining adjustments would be allocated to the year of the change.

(3) Special rules.

In computing the increase or decrease in tax for any prior year under either method, net operating losses and capital loss carryovers are taken into account for years to which no adjustment is allocated.

(a) Pre-1954 adjustments.

Under the 1939 Code, the treatment of adjustments resulting from a change of accounting method depended on whether the change was voluntary or involuntary. The condition for pre-1954 Code years has been carried over into the 1954 Code, as amended by the Technical Amendments Act of 1958.

(b) Involuntary changes.

If the change of method is initiated by the

Commissioner, no adjustments attributable to pre-1954 Code years are taken into account. A change made by a taxpayer on his own initiative to conform to a Federal Income Tax regulation or ruling or one required by another governmental regulatory agency is not an involuntary change.

(c) Voluntary changes.

If the change of method is initiated by the taxpayer, net adjustments applicable to years prior to the 1954 Code must be taken into account. If in excess of $3,000, however, the adjustment may be spread in ten equal installments over the year of the change and the next nine years.

(d) Optional treatment for pre-1954 adjustments.

Instead of spreading pre-1954 adjustments over a 10-year period, taxpayers may elect to have them included with 1954 Code year adjustments. The election must be made within the time for filing the return (including extensions) for the year of change or within 90 days after the Commissioner consents to the change, whichever is later.

(e) Changes in method after 1963.

If the change in method is initiated by the taxpayer in years beginning after 1963, all pre-1954 adjustments must be treated as though they were an adjustment for 1954 Code years.[29]

In the case of change in the over-all method of accounting, such as from the cash method to an accrual

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[29] Ibid., #6081.

method, the term "net amount of the adjustment" means the consolidation of adjustments (whether the amounts thereof represent increases or decreases in items of income or deductions) arising with respect to balances in various accounts, such as inventory, accounts receivable, and accounts payable, at the beginning of the taxable year of the change in method of accounting. With respect to the portion of the adjustments attributable to pre-1954 Code years, it is immaterial that the same items or class of items with respect to which adjustments would have to be made do not exist at the time the actual change in method of accounting occurs.

CHAPTER VI

SUMMARY AND CONCLUSIONS

It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his neads. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

Where inventories are necessary to compute income, an accrual method must be used for purchases and sales, unless the Commissioner authorizes some other method which clearly reflects income. In addition, any combination of permissible methods may be authorized under the regulations. For example, the accrual method, which must be used for purchases and sales, may be combined with the cash basis method for other items of income and expense. But a taxpayer's choice is not unlimited. If the cash basis method is used for income, it must be used for expenses. And if the accrual basis method is used for expenses, it must also be used for income.

Briefly, the cash basis method of accounting is the

method used by most individuals. Under it, income is reported for the year when it is actually or constructively received, either in the form of cash or its equivalent, or other property. Deductions or credits are taken for the year in which actually paid, unless they should be taken in a different period to reflect income clearly (examples would include depreciation allowances). These are requirements imposed by the law. A taxpayer on the cash basis method cannot report income in a year other than that in which it is received, whether or not he may have to put deductions or credits in a year other than that in which they are paid.

On the accrual basis, income is reported when earned, whether or not is has been actually or constructively received. Deductions or credits are allowed in the year they are accrued or incurred, unless properly allowable in another year. This qualification refers to a clarification of the rule for prepaid expenses, and conforms to the general accounting principles applicable to the time when an expense is properly chargeable.

Under the cash basis method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. Further, a taxpayer using this method may also be entitled to certain deductions in the computation of taxable income, which do not involve cash disbursements during the taxable

year, such as the deductions for depreciation and depletion. If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made. An example is an expenditure for the construction of improvements by the lessee on leased property where the estimated life of the improvements is in excess of the remaining period of the lease.

Under the accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. However, any expenditure which results in the creation of an asset having useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred. While no accrual shall be made in any case in which all of the events have not occurred which fix liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy.

In selecting the accounting method, one disadvantage of the accrual basis should be considered--the accrual basis makes it more difficult to shift items of income and

expense from one year to another. The cash basis taxpayer may be able to induce clients or customers to pay fees, rents, interest, and other obligations in advance or to put off payment until a later year. Likewise, he can control expenses to some extent by accelerating or deferring payment for items such as advertising, supplies, repairs, interest and taxes. Manipulations of this sort are not nearly as easy in the case of an accrual basis taxpayer. Such a taxpayer can, however, defer income by shipping and invoicing as little as possible during the closing days of a year in order to reduce income for that year. Or he can accelerate expenses by requesting the delivery and billing of supplies, etc., before the end of the year.

The basic idea under the accrual basis method is that the books shall immediately reflect obligations and expenses definitely incurred and income definitely earned regardless of whether payment has been made or is due. Expenses incurred in operations for a particular year are properly accrued for that year although payment may not be due until the following year. The word "accrue" does not mean that the item is due in the sense of being then payable. The accrual system wholly disregards due dates. Neither must the amount of an incurred liability be accurately ascertained in order to accrue it.

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APPENDIX A

SAMPLE QUESTIONNAIRE

1. Which method of accounting do you use to determine the revenues and expenditures for your business?

Cash basis method _____

Accrual basis method _____

Other method (name of it) _____

2. If you have used that method more than five years consistently, what is the main reason of using that method?

It results in less tax than other methods _____

It is an easier method to compute income and expenses than other methods _____

Other reason (briefly explain) _____

3. If you are planning to change to another method soon, what is the disadvantage of the method which you have used?

It is too complicated in recording transactions ____

It results in more tax than other methods _____

Other reason (briefly explain) _____

4. Which method of accounting did you use before you changed to the method you use now?

Cash basis method _____

Accrual basis method _____

Other method (name of it) _____

5. If you have changed from another method to the one which you use now, when was it?

Before 1954 _____

After 1954 _____

6. If you have changed from another method to the one which you use now, who initiated the change?

You (taxpayer) _____

The Commissioner _____

7. Did your taxable year influence you to adopt the method of accounting you use now?

Yes _____

No _____

8. Do you expect the income tax rates to go up or down in the foreseeable future?

Will go up _____

Will go down _____

No change _____

9. If you are on an accrual basis and sell merchandise on credit, and if a debtor were in bankruptcy at the close of that year, what would you do about that transaction?

Will include that in the income of that year _____

Will not include that in the income of that year ___

10. If payments were received in advance, and were returnable upon the happening of some specified condition, would you include that income in this year's income or in the income of a later year?

This year's _____

Later year's _____

11. If your method of accounting is the cash basis method, how would your business treat the following case?
Insurance premiums paid in advance for more than one year.

Deduct the total amount in the year you made payment _____

Deduct the total amount over the period of insurance coverage _____

12. Do you deduct from your current year's income the estimated costs and expenses attributable to such income although these may be incurred in future years?

Yes _____

No _____

13. If you have advertising expenses incurred or paid in advance although the benefits of them may not be reaped until some future period, when would you deduct the expense?

This year _____

Later year _____

Prorate over the years _____

14. When would you deduct the following expenses?
You made payments for advance rental and salaries to employees for services to be rendered in the next year.

Deduct the amount in this year _____

Deduct the amount in the later year _____

15. Which method of accounting would you adopt to determine revenues and expenditures of your business in the case of your business selling merchandise on the installment plan?

Cash basis method _____

Accrual basis method _____

Other method (name of it) _____

16. During current year's business operation, a certain amount of expense has occurred and you issued a note for the payment. The note was cleared by you in the next year. When would you deduct this business expense?

This year _____

Next year _____

APPENDIX B

MAILING LIST

Alcon Laboratories, Inc.
1400 Henderson St.
Fort Worth, Texas

American Bakeries Company
919 N. Michigan Ave.
Chicago 11, Ill.

American Book Co.
55 Fifth Ave.
New York 3, N. Y.

American International Bowling Corp.
1500 Tryon Ave.
West Eaglewood, N. J.

Beech Aircraft Corporation
9707 East Central Ave.
Wichita, Kansas

Brown Shoe Company
8300 Maryland Ave.
St. Louis 24, Mo.

California Ink Company
545 Sansome St.
San Francisco 11, Calif.

Campbell Soup Company
375 Memorial Ave.
Camden 1, N. J.

Dr. David Greer
24 Crestwood
Houston, Texas

Hemenway Furniture Co., Inc.
919 Texas Avenue
Shrevesport, La.

Hamilton Watch Co.
Columbia Ave.
Lancaster, Pa.

Homestake Mining Co.
100 Bush St.
San Francisco 4, Calif.

International Milling Co.
1200 Investors Bldg.
Minneapolis 2, Minn.

Loft Candy Corporation
38-38 Ninth St.
Long Island City, N. Y.

Pepsi-Cola Company
500 Park Ave.
New York 22, N. Y.

Rex G. Baker, Jr.
Tennessee Bldg.
Houston, Texas

South Western Drug Corp.
8000 Carpenter Freeway, PO Box 6099
Dallas 22, Texas

Sunbeam Corporation
5600 W. Roosevelt Rd.
Chicago 50 Ill.

Time Incorporated
Time & Life Bldg., Rockefeller Center
New York 20, N. Y.

Todd Shipyards Corporation
1 Broadway
New York 4, N. Y.

W. N. Blanton, Jr.
Gulf Bldg.
Houston, Texas

Vita was removed during scanning