

# CASH VS. ACCRUAL ACCOUNTING METHODS

## *Should you be switching?*

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If you are in the service industry and hitting the \$5 million to \$10 million revenue mark, it may be time to switch to the accrual system of accounting. Accrual accounting can also help defer taxes if you receive down payments or retainers for work in advance.

The cash method is the simplest and is used by most small businesses. Income is reported when constructively received - when money or property is available for use without any restrictions. For example, a check is received on December 31, 2007, but it is not deposited until January of 2008. Constructive receipt occurs and income is recognized in 2007. Under the cash method, expenses generally are deductible when actually paid. However, special rules apply to prepaid expenses.

The accrual method measures earnings more accurately than the cash method since it records income and expenses in the period to which they apply, instead of simply reflecting cash flow. Income is reported when earned, without regard for when payment is received.

Initially, a taxpayer chooses an accounting method by using that method on its first tax return and checking the appropriate box. To change the method, a taxpayer generally must receive IRS consent. Under certain circumstances, automatic consent is available; for example, a taxpayer becoming ineligible to utilize the cash basis.

Not all entities can use the cash method of accounting; for example, C corporations with receipts exceeding \$5 million as well as partnerships that have a C corporation partner and receipts exceeding \$5 million. However, a business that would otherwise be required to use the accrual method of accounting may be eligible to use the cash

method if certain requirements are met. Most individuals, S corporations and individually owned partnerships (note: not C corporations) engaged in service activities are allowed to use the cash method of accounting if receipts do not exceed \$10 million and one of the following three tests is met:

1. The principal business activity is providing services, and providing materials is incident to those services
2. The principal business activity is custom fabrication/modification of tangible personal property
3. The principal business activity is not
  - a. Mining activities
  - b. Manufacturing
  - c. Wholesale trade
  - d. Retail trade
  - e. Information industries

Be aware that, even if the principal business activity of a business is described as an ineligible area, the business could still qualify to use the cash method based on one of the other two tests.

Taxpayers are required to use the accrual method for inventory, even if ending inventory is zero. A taxpayer with inventory may use the accrual method or a hybrid method, using the cash method for income and expenses. An exception to the accrual method requirement for taxpayers with inventory is available when receipts are less than \$1 million or for S corporations and partnerships with receipts less than \$10 million.

Consider switching to the accrual system of accounting if you are in the service industry and sales are in the \$5 million to \$10 million range. The IRS may in fact require it. The accrual method may very well be

beneficial to you if you get down payments or retainers for work in advance. Under the cash method, there is really no way to avoid paying tax on these receipts. The accrual method matches income with expenses and is a more accurate measure of financial results. As always, checking with your accountant before making any of these changes is the right thing to do.



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