Quick Topic - Accrual to Cash Basis Net Income - Two Methods

Brief description:
This Quick Topic will cover two different methods of calculating net income on the cash basis for Unanet Financials customers.

What’s covered in this document:

- Accrual basis versus Cash basis of accounting?
- What are the high-level steps required to convert financial statements from Accrual basis to Cash basis?
- Use Cases
- Method 1 - Use a Refreshable Web Query
- Method 2 - Use a Separate Legal Entity in Unanet to display the Cash-Basis Income Statement
- Issues/Considerations
- Additional Information and Sample Documents

Accrual basis versus Cash basis of accounting?

Accrual Basis:

The accrual basis of accounting is used to record revenues and expenses in the period in which they are earned, irrespective of the timing of the associated cash flows. This is the basis of financial statements recognized to be fair and accurate under US GAAP.

Cash Basis:

There are times, however, (usually involving the preparation of a tax return) when a business may instead want to report its results under the cash basis of accounting. The cash basis involves only recording transactions when the cash related to them is either paid out or received.

The only reason that a company should be using cash basis statements is that they file their income taxes using the cash basis of accounting. The accrual basis, instead, should always be used to provide meaningful results-oriented financial information.

What are the high-level steps required to convert financial statements from Accrual basis to Cash basis?

To switch from Accrual basis to Cash basis, these are the high level steps:

- Subtract accrued expenses. If an expense has been accrued because there is no supplier invoice for it, remove it from the financial statements.
- Subtract accounts receivable. Do not include any accounts receivable and their related sales if the related cash was not received within the period.
- Subtract accounts payable. Do not include expenses for any accounts payable that were not actually paid in cash during the period.
- Shift prior period sales. Under the accrual basis, some sales may have been accrued at the end of the preceding period. If the related customer payment was not received until the following period, shift these sales forward into the accounting period when cash was actually received.
- Shift customer prepayments. If customers paid in advance for their orders, these payments would have been recorded as liabilities under the accrual basis. Shift these transactions to sales in the period when the cash was received.
- Shift prepayments to suppliers. If the company pays in advance for some expenditures, these payments would have been recorded as prepaid expenses under the accrual basis. Shift these transactions to expenses in the period when the cash was paid.
- Add back any non-cash adjustments.

Use Cases

<table>
<thead>
<tr>
<th>Method</th>
<th>The business needs to determine where they stand on a cash basis for doing year-end tax planning and for other tax-related activities such as filing estimated tax payments</th>
<th>Creating detail cash basis income statements and balance sheets for use in actually filing tax returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>Method 1 (RWQ)</td>
<td>This method would be useful (and maybe even preferable).</td>
<td>Method 1 is not usable.</td>
</tr>
<tr>
<td>Method 2</td>
<td>Usable but might be overkill if you are trying to come up with estimates</td>
<td>Usable</td>
</tr>
</tbody>
</table>

Method 1 - Use a Refreshable Web Query
One time setup

Create Refreshable Web Queries

The first step is to create an Excel workbook that contains tabs embedded with Refreshable Web Queries (RWQs). For more general information on creating refreshable web queries, please use the link in the Additional Information section below.

There will be two RWQs in the workbook, each based on a saved/shared report (Balance sheet for current year and Balance Sheet for prior year).

- **Current Year Balance Sheet**: RWQ with the current year’s Balance Sheet.
- **Prior Year Balance Sheet**: RWQ with the previous year’s Balance Sheet.

Periodic Basis steps

Create an Accrual to Cash Worksheet

Once the RWQs are complete, a third tab called “Accrual to Cash” will need to be created in the spreadsheet. This tab will calculate current year cash basis net income. The steps to complete this calculation are:

1. Seed the worksheet with accrual basis current year net income.
2. Create a section called “Prior Year Balances” that pulls in the prior year balance for all accrual accounts.
   a. This will reference the Prior Year Balance Sheet tab.
   b. Asset accounts should have positive values; liability accounts should have negative values.
3. Create a section called “Current Year Balances” that pulls in the current year balance for all accrual accounts.
   a. This will reference the Current Year Balance Sheet tab.
   b. Asset accounts should have positive values; liability accounts should have negative values.
4. Subtract the Current Year Balances from the Prior Year Balances for those accounts that should impact accrual to cash conversion (AP, AR, etc).
   a. This represents the year over year increase (decrease) in cash basis net income.
5. Add or subtract any other adjustments necessary to estimate the cash basis income such as:
   a. Differences between Tax and Accrual based depreciation (e.g., typically the difference between straight line and accelerated depreciation).
   b. Fixed Assets that were capitalized for accrual purposes but will be expensed for tax purposes.
   c. Expenses that are not allowable for cash basis tax purposes (e.g., only a portion of meals expense is deductible for tax purposes).
   d. Other items required to adjust between accrual and cash basis tax return income (see your tax preparer for other items).
6. As a sanity check, the change in cash balances (Current year minus previous year) should equal the cash-basis net income.
7. Following is an example of how this might look. (attached is an excel file providing another example, in more detail).

<table>
<thead>
<tr>
<th>2015 Accrual Basis Net Income</th>
<th>100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014 Balance Sheet Balances</td>
<td></td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>40,000</td>
</tr>
<tr>
<td>Other Assets</td>
<td>2,000</td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>(12,000)</td>
</tr>
<tr>
<td>Accrued Expenses</td>
<td>(3,000)</td>
</tr>
<tr>
<td>2015 Balance Sheet Balances</td>
<td></td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>50,000</td>
</tr>
<tr>
<td>Other Assets</td>
<td>1,000</td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Accrued Expenses</td>
<td>(1,000)</td>
</tr>
<tr>
<td>2015 Depreciation</td>
<td>8,000</td>
</tr>
<tr>
<td>Cash Basis Net Income</td>
<td>95,000</td>
</tr>
</tbody>
</table>

Type of Adjustments

Your tax accountant or CPA can discuss with you the types of adjustments you would want to enter in order to have a more accurate reflection of what the cash basis income is likely to be.

Method 2 - Use a Separate Legal Entity in Unanet to display the Cash-Basis Income Statement
This method is used if you wish to maintain the accrual to cash conversion within Unanet, and also requires detailed cash basis financial statements.

This is the preferred method for maintaining official records as it will maintain a complete history of all of the adjustments made and can potentially be used to create some of the backup reports required in the tax returns. The statements could be adjusted to tie to the tax return info once the tax return is submitted.

These would typically be created on an as needed basis - perhaps at the end of each quarter for estimate tax payment purposes and in November for calendar year filers to see where they stand close to year end for tax planning purposes.

We do not recommend that you export the existing Trial balance from your Legal Entity and import it into new Legal Entity. The reason for this is that it is difficult to differentiate between accrual balances and adjustments.

One time setup

1. Create a new Legal Entity.
2. If desired, create a separate login to that Legal Entity or grant access to that Legal Entity only to the one user who has permission to view the Accrual to cash data.

Periodic Basis steps

This does not need to be done at year-end only. It can be done anytime, e.g., at the end of the quarter or when tax filings need to be made. It can be done as often as you need to create cash basis statements to create income for estimated tax payment purposes.

1. Enter the accrual to cash adjusting entries into the new Legal Entity. A combination of reversing and normal Journal Entries can be used to book the adjustments depending on if they were temporal or static. (For example, book AP reversal as a reversing entry, but book differences in fixed asset capitalization as a normal Journal Entry.)
   a. Create entries in the new Legal Entity as of the end of the prior fiscal year to adjust the prior year balance sheet to match the tax basis balance sheet.
      i. Use reversing Journal Entries to reflect timing differences such as the reversal of AR and AP balances, Accrued Expenses and any other items that should be recognized in following fiscal years. These entries should reverse out in the following fiscal year. The entries should be made in a sufficient level of detail to make sure the reversals end up in the correct accounts for the following fiscal year.
      ii. Use a normal Journal Entries to reflect any permanent differences between Accrual and Cash Basis Tax statements such as differences in capitalization treatment of fixed assets, depreciation or other differences that should not be automatically reversed into the following fiscal year.
      iii. Set the entries up as recurring entries if that will be useful for creating future period adjustments.
   b. Create entries similar to the entries entered to tie out the previous year balances to the income tax information as of the end of the reporting period (e.g., if doing quarterly statements, create the entries as of the end of each quarter). Add/delete any no longer required entries as appropriate.
   c. Examples of the types of entries made are listed below:
      i. Accounts Receivable
      ii. Accounts Payable
         1. Run Open AP as of period end.
         2. Enter the open AP document numbers into the Vendor Invoice Export to get the detailed GL accounts you will need to make your Journal Entry. (Note: A Unanet export template could be created to do this for you).
         iii. All other prepaids, deposits and distributions should be in the Journal Entry (can be multiple journal entries or recurring entries as appropriate). Your accountant will advise you on which adjustments are necessary to get to your cash basis income.
   2. If necessary, a RWQ can be created that combines the two legal entities to show the consolidate cash basis statements. Alternatively, you can enter these into a spreadsheet manually.

Issues/Considerations

1. Running the Vendor Invoice Export to get the detailed accounts is not as easy as it seems. You must first identify which invoices are actually open and only select these in the export. This should and probably will be replaced with a custom export in the format of a Journal Entry Import, but you will always have to select only the open items.
2. If you have limited experience in how to do the accrual to cash, you may not have the ability to validate the data without the help of an accountant. You will want to involve your accountant or CPA.
3. This is not the same as the Quickbooks “Accrual to Cash” conversion button that will take the income statement and convert it to cash. Keep in mind, however, that the QuickBooks accrual to cash does not actually provide the tax cash basis statements without making most of the adjustments noted above. The primary thing it does is to reverse out the AR and AP balances.
4. The accrued balances in AR, AP, etc. are not always related to income/expense accounts (e.g., AP related to Fixed Asset purchase, Accruals for balance sheet purchases, etc.). As a result, there needs to be a way to reflect that in the cash basis information. This could easily be done in Method 2, but would need to show up as a manual adjustment in Method 1.
5. There are other differences between the way things are treated for taxes versus accrual accounting statements such as the following items. (Note that none of these are addressed by the QuickBooks “cash basis” statements. In other words you can’t just run the statements in QuickBooks and be done with it).
   a. Depreciation method (e.g., accelerated for tax vs. straight line for books).
   b. Capitalization rules (e.g., can write things off immediately for tax that are capitalized.
   c. Unallowable expenses (e.g., only half of meals expense can be deducted).
   d. Tax credits and adjustments.

Additional Information and Sample Documents

Accrual to Cash Demo.xlsx
trial balance from MYCO period 5 version1.csv
trial balance from MYCO period 12 version6.csv
Accrual to Cash Journal Entry Import Period 12 URCO ONLY.csv
Accrual to Cash Journal Entry Import Period 5 URCO ONLY.csv
KC - Refreshable Web Queries