The Lafayette Village Community ("LVCA") changed from the Cash Basis method of accounting to the Accrual Method of accounting in 2006. For the year ended 12/31/06, LVCA had net income of $6,858 using the Cash Basis but a net loss of $5,979 using the Accrual Method.

The issue is why the change in accounting principle resulted in a $12,837 reduction in net income.

Reason for Accounting Change
Generally, the Internal Revenue Code requires taxpayers to compute taxable income using the same accounting method to compute income in keeping their books. LVCA files its tax return using the accrual method; therefore the books should be kept under the accrual method.

Cash Basis of Accounting

Under the Cash Basis method income is recognized when it is received, and expenses are recognized when paid.

Accrual Method of Accounting

Under the Accrual Method income is recognized when it is earned and expenses are recognized when owed. The Accrual Method looks to the "all-events test" to determine when income is earned and expenses incurred.
Under the all-events test:

- Income is recognized for the period when all the events have occurred that fix the right to receive income.
- Expenses are recognized in the period in which all the events have occurred that establish the fact of the liability.

Cash Basis Examples
Most people use the Cash Basis method to keep their individual records, in fact the IRS requires most individuals file their taxes under the Cash Basis. As described above, expenses are recognized when paid using this method. Think of your check book. You may receive a credit card bill on the 24th of December that isn't due until the 8th of January. You don't enter anything into your check book when you receive the bill, only when you write the check. If you waited until January 4th to write the check, then you would recognize the credit card expense in January, you would not back-date it to December. After all, your bank statement at December 31 would not include a check written on January 4th.
Another Cash Basis example: Suppose LVCA hired someone to replace three lights in the community. The contractor does the work and LVCA receives a bill for $3,000 in December that is due January 10th. Again, under the Cash Basis, LVCA wouldn't enter any transactions in December, a bill has been received but no check has been written. At December 31st even though we know we owe the contractor $3,000, no liability or expense is recognized, and the cash position doesn't change. On January 8th, LVCA

sends a check to the contractor for the full amount. Once the check was written, then – and only then under the Cash Basis- is the expense booked and the cash reduced to reflect the outstanding check.

It is important to note that under this method, the expenses weren't recognized until January (when paid) even though the work was completed in December.

Accrual Basis Examples

Generally, companies, and organizations use the Accrual Method. Using the example of the credit card bill I used above, you know that your bank balance at December 31 isn't entirely available for you to spend because you're going to have to pay your credit card bill by January 10th. Keep this in mind when you think of the Accrual Method.

Let's go back to the example with the contractor. On December 20th he finishes installing the lights and LVCA receives his bill for $3,000. Under the Accrual Method, LVCA would book the expense and liability as soon as the bill was received, even though it won't be paid until January. The journal entry would look like this:

Light Expense	3,000	
Accounts Payable		3,000

Note: On Dec. 20 LVCA has recognized $3,000 worth of expense, which effectively reduces income by $3,000 even though our cash position hasn't changed.

With this entry on the books at year end, LVCA management knows that at least $3,000 needs to be set aside for bills due in early January. The all events test was mentioned earlier. In this example, the contractor has installed the lights, we can't change the terms and ask for a fourth light, or to move the lights, etc… therefore, all events have occurred for LVCA to incur a liability. Under the Accrual Method, we know we owe the contractor for the service performed therefore we have to book the liability and corresponding expense.

When LVCA writes the check in January, the following journal entry is recorded:

Accounts Payable	3,000	
Cash		3,000

Now LVCA's cash position has changed, but note no expense was recognized with this last journal entry. The expense was recognized with the first journal entry that was booked in December. The job wasn't completed in January, it was completed in December, and this matches the expense with the proper period. LVCA didn't have any light work done in 2007 so Light Expense for 2007 should be $0.

The Accrual Method can be tricky. Assume LVCA hires a contractor in late December to install three lights for a total of $3,000 with the work to be completed by January 20th. If at December 31, he has installed only two of the lights, LVCA still has to book a liability even though we haven't received a bill. Why? The all events test. If the rest of the job goes south, at a minimum LVCA will have to pay for the two lights that were properly installed. In this case a liability would be booked for only a portion of the contract, after all if the third light never gets installed, LVCA doesn't have to pay for it. Assuming two-thirds of the project is done at December 31, the journal entry would look like this:

Lights Expense	2,000	
Accounts Payable		2,000

The contractor may install the third light on time, but even if he doesn't we know we have to pay for at least the two lights that were finished at year end. The point here is LVCA will have to book a liability even though a bill has yet to be sent. Generally, these types of entries are only booked for material items such as construction projects. Assuming the contractor finishes installing the third light in time and bills LVCA, the entry LVCA will book when the check is cut is:

Light Expense	1,000	
Accounts Payable	2,000	
Cash		3,000

Note how most of the expense was recognized in December, because most of the work was performed in December.

Conclusion

It would appear, that at December 31, 2006, LVCA had unpaid bills totaling approximately $12,800 (the difference between a gain of $6,858 and a loss of $5,979). Under the accrual method, an adjustment had to be made to recognize these bills as liabilities. Under the cash basis these bills would have stood outside the accounting system until a check was cut.

In order to give a more detailed analysis, it would be necessary to review LVCA's financial records for December 2006 and January 2007. It is likely a review of checks written in early 2007 were for services received in late 2006.