HORNBEAM'S GUIDE

Hornbeam

TO

CASH ACCOUNTING

By Phil Needham

Hornbeam Accountancy Services Limited

Hornbeam House   Bidwell Road   Rackheath   Norwich   NR13 6PT

Tel: 01603 720424 email: info@hornbeam-accountancy.co.uk

www.hornbeam-accountancy.co.uk @HornbeamUK

Cash Accounting - What is it?

This is the possibility to account solely on the basis of cash receipts less cash payments. In particular out go all the 5,000 pages of generally accepted accounting practice (GAAP).

Receipts are all receipts into the business – cash receipts, bank receipts, and (interestingly) receipts in kind seem to be covered too! Receipts are for trade sales, equipment sales, grants, supplier refunds (but not loans). Invoices to customers *who haven't paid are not* counted as income.

Costs are only allowed when paid, so unpaid supplier invoices are not allowed. Purchases made under HP are only allowed as the HP is paid. But on the other hand capital purchases of capital equipment are allowed as the payment is made (there is no system of capital allowances or depreciation). Similarly stock purchases are allowed when the stock is purchased, there is no need to wait until the stock is sold before bringing it into cost of sales.

One thing to note is that this is not an income and expenses record, as many hundreds of thousands of businesses have been used to submitting to HMRC (with no legal permission, simply HMRC didn't mind). Income and Expenses accounts did not attempt to calculate debtors, creditors, or stock or produce a balance sheet; but instead matched actual sales made (whether paid or not) with actual costs (whether paid or not). In practice this system was only used for the smallest businesses with minimal stock, debtors and creditors. There is still no right to prepare accounts on an income and expenses basis for HMRC, but only time will tell whether HMRC attempt to stop this practice.

From my time at the Office of Tax Simplification, I believe that most people at HMRC and the Treasury did not realise that Cash Accounting is different from Income and Expenditure Accounting.

Who is Allowed to use Cash Accounting?

This is an optional scheme (not compulsory) for businesses that meet the criteria….

Allowed Sole Trader or Partnership	**Prohibited** Ltd Company, LLP
Turnover less than the VAT registration Limit (currently £81,000), or twice that for recipients of Universal Credit and businesses already cash accounting.	Businesses wanting to transfer in with turnover greater than the VAT threshold, businesses already cash accounting with turnover exceeding twice the VAT threshold.
Not specifically excluded (as opposite)	* Lloyds underwriter * Business with herd election (i.e. some farms) * Persons with a section 221 profit averaging election * Businesses which have claimed premises renovation allowance * Business that carry on a mineral extraction trade * Businesses that have claimed R & D allowance
Businesses with accounting periods ending after 5 April 2013	Accounting periods ended before 6 April 2013

Actually there will be an awful lot of small businesses which fall into the allowed category.

Businesses meeting the criteria can enter or leave the scheme at any time, but must indicate to HMRC whether they are in or out by ticking the appropriate box on the tax return.

Restrictions

The cash accounting system might be very attractive for some clients, and equally poses a threat of lost revenue to HMRC. Unsurprisingly there are a number of restrictions intended to protect revenue for the Treasury, which pose pitfalls to clients. Here are some of those restrictions.

Losses may only be carried forward, it is not possible for losses from cash accounting to be carried backward or offset against other income. *Whilst no one sets out to make losses, sometimes the option to offset start-up losses against other income is a major help to new or investing business*

Interest cost will only be allowed under cash accounting up to a limit of £500, but the rules for identifying allowable interest are extraordinarily generous.

Stock and Work In Progress are counted as receipts of the business when leaving the scheme.

Expenditure The rules as to **WHAT** expenditure is allowable are no less complex than before, only expenditure wholly and exclusively for the purposes of the trade, in general. Only capital expenditure that would be qualifying expenditure under the rules of CAA 2001. Special rules for loan interest.

Transitional Rules

It is important to understand what happens when a business enters or leaves the scheme

Entering the scheme

Fixed Assets	The written down value of fixed assets (capital allowances not yet claimed) is an allowable cost of the first period of cash accounting.
Stock	Stock in hand at the end of GAAP accounting will be a cost in cash accounting. The effect is the same as though opening stock were in the accounts but closing stock is not.
Debtors	A transaction that has been recorded as income but not yet paid is not recorded twice under this system, so as the receipts for the first year of cash accounting are recorded, receipts relating to opening debtors are not counted. This is not quite the same as saying that opening debtors can be deducted from receipts. Only those debtors that are paid can be deducted there would seem to be not relief for bad debts at the transition.
Creditors	A cost which has been claimed but not been

	paid at the end of GAAP accounting cannot also be claimed when paid under cash – accounting. In other words opening creditors are deducted from payments.

Leaving the scheme

Fixed Assets	Any unallowed costs (i.e. unpaid balance on assets being purchased by HP) go into the pool. But generally there will be no adjustment.
Stock	Stock at hand on leaving the scheme must be accounted as a receipt (i.e. there is no 12 month delay before stock is brought in)
Debtors	Debtors will be brought in at the end of the first GAAP period.
Creditors	Creditors will be brought in at the end of the first period.

Winners and Losers, and how to use the scheme

Winners

Businesses (meeting the criteria) which

- have a large unused capital allowances or capital expenditure planned, which may allow them to defer paying tax for many years. ***But remember no sideways or backwards loss relief and very limited relief for interest paid.***

- Have large amounts of stock or debtors but relatively small amounts of creditors.

Commentary

I am not convinced that businesses have to do much less record keeping under this scheme, which seems to be the government's reason for promoting it. For example:

- Certainly any business that wants to know how it is doing will need to keep full accounts,

- any business owner applying for a mortgage or an overdraft will probably need full accounts,

- any business with debtors needs to keep a record so that he knows who owes the business money.

- There is even an argument that businesses will need to see which system favours them each year in order to minimise their tax, this requiring more work!

I recently assessed the stock of a start-up business, in order to prepare a set of management accounts, and found that the client was not making the margin he thought he was. He was actually making a loss and was quickly able to change his selling price calculations to correct this. He had been building up stock levels and making cash losses as he expected, but without proper accounts he would have lost a lot of money before he discovered his error…

None the less for tax purposes this client would have to consider the cash accounting system for tax reporting - £10,000 of stock built up over the first 6 months is a cost under the cash accounting system, which shelters £10,000 of conventional profit from tax. However because cash accounting losses are blocked from backwards or sideways relief in this client's case he was better to get relief for £2,000 of losses against earned income, than carry forward £12,000 of cash accounting losses against uncertain future profits.

Examples

Consider a start-up business run by Henry with the following results, and no other income.

Tax Year	**Turnover**	**GAAP profit**	**Stock**	**Cash Profit**
1	**£40,000**	**£10,000**	**£10,000**	**£0**
2	**£80,000**	**£20,000**	**£10,000**	**£20,000**
3	**£160,000**	**£60,000**	**£10,000**	**£60,000**

In ***Year 1*** there is not much to choose between cash accounting and GAAP accounting, if Henry has other income then cash accounting will probably be preferable (as it saves tax on £10,000) but if there is no other income Henry is better to use GAAP accounting and get allowance for the stock in a year when he is a taxpayer.

In ***Year 2*** Henry no longer has the option of joining the scheme, but can stay in if he joined in year one. If he stays in cash accounting or chose GAAP accounting in year 1 his profits will be the same and so will his tax.

If Henry moves to GAAP accounting at the start of the period £10,000 must be added to the year one tax return (in other words the cash scheme was a complete red herring and has never applied, but costs will have been incurred). If he moves to GAAP accounting at the end of the period he must add £10,000 to the year 2 profit paying basic rate tax on £30,000 rather than £20,000.

If he was not a taxpayer in year 1 this is a bitter pill to swallow for a “simplification” measure. However the position is worse if he delays to year 3.

In ***Year 3*** if Henry has been a GAAP taxpayer for the whole time he pays tax on £60,000. However if he had been cash accounting he MUST leave the scheme (as his turnover exceeds £140,000) and must bring in the closing stock as a receipt, so he will pay tax upon £70,000, and the extra £10,000 will be taxed at 42%!

In conclusion Cash accounting is unlikely to be helpful to fast growing small businesses.

Example 2

Heather’s business has been turning over £50,000 and making, £30,000 net profit for many years. She comes to see her accountant with a plan to buy a £100,000 machine that will enable her to double her turnover and her net profit. Annual investment allowances are £25,000 and writing down allowances are 18%.

	Turnover	Profit	Capital Allowance	Taxable Profit
Current year	£70,000`	£42,000	£38,500	£3,500
Year 1	£100,000	£60,000	£11,070	£48,930
Year 2	£100,000	£60,000	£9,077	£50,923
Year 3	£100,000	£60,000	£7,443	£52,557

But with an immediate move into cash accounting

	Turnover	Profit	Taxable Profit	(Reduced) /Increased
Current year	£70,000`	£58,000 loss	0	(£3,500)
Year 1	£100,000	£60,000	£2,000	(£46,930)
Year 2	£100,000	£60,000	£60,000	£9,077
Year 3	£100,000	£60,000	£60,000	£7,443

I drafted this example thinking to prove how effective cash accounting might be in advancing allowances and indeed it shows that the year 1 profit is wiped out with very considerable tax saving. But the accountant must set against that a long trail of year's additional tax being paid at 42% whereas most of the saving is only at 29%, in spite of the initial saving, over time cash accounting will cost Heather nearly £4,000 in higher rates of tax!

Example 3

However consider Hazel who has a small retail business making a consistent £70,000 turnover and £35,000 profit. She holds £30,000 of stock and averages about £5,000 of creditors. Moving to cash accounting will bring in an extra £25,000 of cost as a one off… which is enough to wipe out her tax for one year.

Example 4

Or consider Hamish who is a contractor with negligible costs. Years fluctuate a bit but he is well within the cash accounting parameters. Hamish has about £6,000 of debtors at his year end, by moving to cash accounting he reduces his taxable profit by a one off £6,000.

Conclusion

For consistently small businesses with Stock, Debtors, or unused Capital Allowances there will be a one off saving from moving to cash accounting, but trying to use the scheme to benefit growing businesses is more than likely to backfire.