Chapter 03 Accounting Basis and Methods

100 Basis of accounting refers to the methodology under which income and expenses are recognized in financial statements and records. Every taxpayer must use a consistent accounting method to report income and expenses. The manner by which a taxpayer computes the amount of income, gains, losses, deductions and credits, and the tax year for which each item must be reported, constitutes the taxpayer's tax accounting method. The most commonly used accounting methods are the cash basis and the accrual basis.

101 The cash basis (cash receipts and disbursements) is the accounting method used by most individuals. Income is generally reported in the year that it is actually or constructively received in the form of cash, or its equivalent, or other property. Deductions or credits are generally taken for the year in which the related expenditures are actually paid, unless they should be taken in a different period to more clearly reflect income, such as depreciation allowances and prepaid expenses.

102 Bad debts do not constitute a loss as such under the cash receipts and disbursements method. The expenses, liabilities or credits of one year cannot be used to reduce the income of a subsequent year.

103 The accrual basis is the accounting method that records revenues and expenses when they are incurred, regardless of when cash is exchanged. Expense are deductible on the accrual basis in the year incurred, regardless of when payment is made. The purpose of an accrual method is to match income and expenses in the correct year.

104 The net income shall be determined in accordance with the accounting basis employed by the taxpayer, whether it be a fiscal year or a calendar year and in accordance with the method of accounting employed whether it be cash or accrual. The accounting method used by a taxpayer must clearly reflect income and expenses. The taxpayer's method of accounting must be consistent; no method of accounting is regarded as clearly reflecting income unless all items of gross profit and deduction are treated with consistency from year to year.

105 The initial return may be filed in accordance with the basis and method elected by the taxpayer as long as it is in keeping with generally accepted principles, is in accordance with the basis and method of accounting regularly used by the taxpayer, and reflects the taxpayer's correct income. Arbitrary changes in the basis or method of accounting employed by the taxpayer are not permitted except in cases where such changes have been approved in advance by the Commissioner.

106 Where no accounting basis has been established by the taxpayer, or where the method employed does not clearly reflect income, the Commissioner shall prescribe a method that will clearly reflect income, and the taxpayer for whom the method is prescribed shall be bound by the same until such time as it is shown to the satisfaction of the Commissioner that a method proposed by the taxpayer will reflect such income with equal results.

107 The expenses, liabilities or credits of one year cannot be used to reduce the income of a subsequent year. If a taxpayer does not within any year properly deduct their expenses, losses, interest, taxes or other charges, they cannot deduct them from the income of the next or any succeeding year.

108 (Reserved)

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