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Mr. Chairman and members of the Committee, thank you for inviting me to testify today. My name is Stephen Mankowski. I am a Certified Public Accountant, member of the American Institute of CPAs and the National Secretary and National Tax Policy Chair of the National Conference of CPA Practitioners, (**NCCPAP**), as well as the Vice President of the Delaware Valley Chapter of **NCCPAP**. **NCCPAP** is a professional organization that advocates on issues that affect Certified Public Accountants in public practice and their small business and individual clients located throughout the United States. **NCCPAP** members serve more than one million business and individual clients and are in continual communication with regulatory bodies to keep them apprised of the needs of the local CPA practitioner.

Accompanying me is Mr. Edward Caine, President of **NCCPAP**. We recently merged our practices.

We have been preparing tax returns for over 30 years. Our firm annually prepares well over 1,100 small business and individual tax returns as well as sales tax and payroll tax returns. As a result, we are in the trenches with clients discussing their tax, financial and personal issues, and the impact of events on them. Although our clients are mostly in the Pennsylvania, New Jersey and Delaware area, we have clients in New York, South Carolina, Ohio, Florida, Michigan, Alabama, California, Massachusetts, Nebraska, Tennessee and Washington DC. In total, our firm files serves clients in over 30 states and also services clients in Canada and Europe. In this respect our practice is the same as many members of **NCCPAP** and other smaller CPA firms throughout the United States.

Discussions surrounding the proper basis of accounting most likely began the moment a second basis was developed. Today, we not only have the two primary bases – cash and accrual – but also others including tax, regulatory and "other". Any basis other the accrual method is referred to as an "Other Comprehensive Basis of Accounting (OCBOA)". For purposes of this testimony, I will be discussing the cash and accrual bases of accounting.

To further complicate the discussion, there are two distinct cash bases of accounting – cash and modified cash. Pure cash presentations in financial statements are very rare because cash receipts would not only include sales receipts but also proceeds from debt and fixed asset sales, and cash disbursements would include expenses, purchases of fixed assets, and loan repayments. This approach does not provide useful or realistic financial statements. Rather, a modified presentation has evolved to address these concerns. Therefore, when the term "cash basis of accounting" is used, the presenter is truly using the modified cash basis of accounting. As such, when discussing the cash basis of accounting, it is really a Modified Cash Basis, but hereinafter will be referred to as “cash basis”.

Under the cash basis of accounting, a taxpayer can defer income until cash is received but must also wait to deduct expenses until the amounts have actually been paid. Currently the cash basis of accounting is available for businesses operating as sole proprietors, S Corporations, partnerships that do not have a “C” Corporation as a partner, and personal service corporations (PSCs). A PSC performs activities in the fields of health, law, engineering, accounting, etc. whereby substantially all of the stock of the corporation is owned by employees performing services for the corporation in connection with those activities. In addition, some C Corporations and partnerships with C Corporation as partners can use the cash method if their average annual sales for the previous three years are less than $5 million.

Accrual accounting is considered to be the standard accounting method for most other companies. The accrual method provides a more accurate picture of the company's current financial condition, but its relative complexity makes it more expensive to implement. Generally, a small business that receives income from producing, purchasing or selling merchandise must compute its inventory and use the accrual method of accounting. However, a small business with average annual receipts of $1 million or less can still use the cash method and account for inventory as materials and supplies. The costs for these materials and supplies would be deducted in the year the business sells the merchandise or pays for the items, whichever is later. Resellers with gross receipts of $10 million or less are not required to use the accrual method of accounting.

Currently, if a small business has sales that require an accrual method of accounting or if the business simply wishes to convert from the cash method to the accrual method they must file IRS Form 3115, Application for Change in Accounting Method. The filing of this form is a request for a change in accounting method, not a guarantee. In preparing this form, the taxpayer must take into account any and all changes required to convert to an accrual basis as well as pay a filing fee.

The need for the accrual method arose out of the increasing complexity of business transactions and a desire for more accurate financial information. Selling on credit and projects that provide revenue streams over a long period of time affect the company's financial condition at the point of the transaction. Therefore, it usually makes sense that such events should also be reflected on the financial statements during the same reporting period that these transactions occur.

The form to request a Federal Employer ID number (EIN) requires that an accounting method for the business must be selected. This form is completed prior to the business opening. Often, the primary understanding of accounting and record keeping of the business owner(s) falls under the cash basis of accounting. Throughout their adult lives, as individuals they have received W2s, 1099s, 1098s, and/or real estate bills. All of these documents were prepared under the cash basis of accounting. In fact, almost all personal tax returns are prepared on a cash basis of accounting. Therefore, when opening a business or even purchasing a rental property, the cash basis of accounting is the initial thought that comes to mind for the taxpayer.

In establishing a business, hopefully the business owners have consulted with professionals – attorneys to incorporate the entity, if applicable, and CPAs to ensure the proper business structure. Part of a CPA's job is to ensure that taxpayers comply with the tax codes so that they pay their fair share of taxes. Many business owners want to incorporate their business believing that there are special tax advantages, such as fewer tax audits. They don't realize that there are other considerations including keeping separate books and records, paying themselves a salary as an incorporated business is required to do, additional tax files, and the list goes on.

In recent years, Limited Liability Companies (LLCs) have become a common choice of business structure of the new small business. Often, however, the business owner is not aware of the various tax ramifications. If there is only one owner, the business is taxed as a sole proprietor and all of the business activity will be reported on Schedule C of the owner's individual tax return. With multiple owners, the entity would be taxed as a partnership. The entity can elect to be taxed as an S-Corporation regardless of the number of owners provided that none of the owners are corporations. Under the rules of S Corporations, owners with greater than a five percent ownership interest are required to draw reasonable compensation in the form of a salary where the tax withholdings can be sufficient to remove the burden of making quarterly estimated tax payments as individuals.

Regardless of whether the entity is taxed as an S corporation or partnership, the owners are subject to pass-through income based upon their ownership interest or partnership agreement. Often, this income relates to funds that are not always immediately available for distribution to the owner(s), which may be another challenge to taxpayers who have to follow accrual based accounting as this may trigger phantom income. Owner(s) may choose to keep the net income in the business to help fund expansion, debt service or unpaid bills. Countless times during tax season after the owner(s) receive Form K-1 from their partnership or S corporation, we have to explain to business owners why they are paying taxes on business income that they have not received. This is what is referred to as pass-through income of the business and is taxed at the individual level - frequently at lower tax rates than if taxed at corporate levels. Further complicating pass-through income is the fact that most partnership income is also subject to self-employment taxes.

Many small businesses still operate under the cash basis for tax purposes but opt to prepare accrual basis financial statements, as this **MAY** show them in a better financial position. This is often the case when there is a need for financing. In addition, many banks prefer an accrual basis as it provides them a more comprehensive view of the financial position of the entity because of the inclusion of accounts receivable and accounts payable in the financial statements.

Often business owners do not have the accounting background to properly and adequately track and report revenue and expenses in any manner other than cash basis without the assistance of CPAs, EAs, accountants and bookkeepers. Many owners simply think on the basis of cash in and cash out and give their accountants their bank statements, check stubs and invoices to prepare their financial books which are used solely to prepare their tax returns. Many small business owners do not have systems in place to fully track accounts receivable or accounts payable. Once the financial activity is recorded, small business owners would then need to adjust these statements into an accrual basis. These adjustments can include uncollected revenue, unpaid payroll and related liabilities, prepaid expenses, inventory, etc. Not only will the owners be responsible for knowing what adjustments need to be made, they also must be able to determine the valuation of these adjustments.

Despite the business owner's reliance on accounting professionals, the fiscal responsibility still falls on the owners. The business owners are and will remain responsible for all of the information that appears on their tax returns. The fact that their tax returns are professionally prepared does not alleviate the taxpayer responsibility for the accuracy of the data contained in the tax returns, but many business owners may not have the financial background to make this determination using the accrual basis of accounting.

If small businesses were required to convert their accounting method to the accrual basis, the overall impact might simply be a "one-time" hit. Meaning, once the conversion is complete, the annual effect might not be as significant as one might expect. The "one-time" hit, however, could be very significant depending on the business. Newer entities or entities with minimal accounts receivable or accounts payable would likely have a small tax increase and possibly even a tax decrease. Entities with a larger receivable base, however, would not be so fortunate. To properly convert, they would need to report **ALL** open receivables as current income and all unpaid bills as current expenses. The impact of this added income could propel the owners into higher tax brackets, which in turn could lead to the phase-outs of itemized deductions and personal exemptions, phase-outs of other deductions and credits including tuition and student loans when the increased income is reported on their individual income tax returns. In addition, taxpayers may find themselves subject to the 3.9% Net Investment Income surtax that became effective last year.

These tax increases will not just affect the taxpayer's federal income tax. Rather, additional state and local taxes may also be due because state and local tax returns usually have to be filed on the same basis as the federal tax returns. Further, many municipalities also impose a tax on gross receipts of all businesses.

As discussed throughout the testimony, taxpayers often are unaware of the differences in accounting methods. If they were required to convert, this obviously creates a major business opportunity for CPAs, EA, bookkeepers, etc. Unfortunately, this will also open the door for unregulated preparers to take advantage of unknowing taxpayers and utilize creative accounting.

Over the last few years, I have attended many IRS meetings, including National Public Liaison (NPL) and Working Together Forums. If there is one common thread that has been resonating from the IRS, it has been to reduce taxpayer burden. While this can mean many things, ultimately I believe that the IRS realizes that business and taxes in today's economy have gotten even more complicated. The current tax codes makes compliance even more complicated. In working to reduce the tax compliance burden, the IRS representatives have stressed the importance of e-Filing tax returns and have improved upon this every tax season, added additional features to their website such as "where's my amended return" that allows taxpayers to track the processing of amended tax returns. Further, discussions have also centered on what can be done to ease the stress of taxpayers from regular tax filings and to respond to IRS notices that are sent. Requiring taxpayers to change their accounting methods without any specific reasons would truly be in conflict to what the IRS has been working to achieve.

In conclusion, after reviewing the facts surrounding the differences between cash and accrual basis accounting, I feel that the use of cash basis for small firms remains of great importance and should be continued. It is a method that is consistent with how the owners have been taxed throughout their lives on their personal tax returns and how they realistically live. Converting to an accrual basis would add an additional burden onto them – financial. They would need to retain accounting professionals to guide them in this process. The Federal Government would achieve what can best be described as a "one-time" boost of tax revenue from the conversion. Taxpayers would be paying taxes on net income that neither they nor the business has received and this tax increase will include federal, state and local taxes. If the taxpayer has uncollectable aged accounts receivable, the taxpayer will be able to then write off this revenue and potentially send cancellation of debt notices (a 1099C) to those who owe money to the business. If the business subsequently pays the old accounts receivable, the income would be reported at that time and a method would have to be developed to reverse the cancellation of debt notice. The end result would be that the taxpayer has reduced his or her tax burden and the effect of the conversion to accrual basis is further diminished.

All businesses have the opportunity to elect to track their accounting on an accrual basis. Not all have the opportunity to account on a cash basis. Some larger entities and many of those with inventory are required to account on an accrual basis. However, the majority of businesses are permitted to choose their accounting method. With the guidance of financial professionals, they are able to elect the most appropriate accounting method for their specific business. Forcing a business to use the accrual basis not only complicates their business but also requires the owners to take time away from operations to focus on changing an accounting method. Ultimately, one does not start a business to focus on accounting. Forcing this change will do just that.

Thank you for the opportunity to present this testimony.