Testimony of

Sarah Windham, CPA

Senior Manager

Dixon Hughes Goodman LLP

Charleston, South Carolina

Committee on Small Business

Subcommittee on Economic Growth, Tax and Capital Access

United States House of Representatives

Hearing on

Cash Accounting: A Simpler Method for Small Firms?

July 10, 2014

Chairman Rice and Members of the Committee, thank you for the opportunity to testify on Cash Accounting: A Simpler Method for Small Firms?

My name is Sarah Windham. I am a Senior Tax Manager in the Charleston, South Carolina office of Dixon Hughes Goodman LLP. With over 1,800 people located throughout the region, we are the largest CPA firm based in the Southern United States. Our commitment to our clients' success has led to the development of specialized practice groups, each dedicated to a specific industry and offering comprehensive solutions. One of the firm's professional service areas is Agribusiness. With nearly 60 years of experience serving the agribusiness industry, Dixon Hughes Goodman has developed a deep understanding of the operations and issues affecting various agribusinesses such as food processors, growers, industry associations, cotton ginners and co-ops.

I am a Certified Public Accountant with 15 years of experience. I have extensive experience with agriculture clients, construction and real estate clients, as well as many other small businesses.

I am here today on behalf of the South Carolina Farm Bureau. The South Carolina Farm Bureau is a grassroots, non-profit organization celebrating and supporting family farmers, locally grown food and our rural lands through legislative advocacy, education and community outreach.

I am testifying before you today on the potential negative ramifications of the various proposals in Congress that would eliminate, for many taxpayers, the use of cash accounting for the purpose of calculating income tax liability. These adverse effects include a significant increase in the time dedicated to tax compliance, which will deter farmers and other small business owners from focusing on making a living, as well as, an increase in the cost of tax compliance that would reduce the profitability of many farmers and small businesses who already work with very thin margins. Another effect would be a significant acceleration of tax liability without the cash available to pay the taxes on uncollected, yet taxed, income. These adverse effects would fall disproportionately on small businesses, such as farmers and professionals engaged in the fields of law, accounting, engineering, architecture, health, actuarial science, performing arts, or consulting.

Almost all farmers use the simple, straightforward cash method of accounting in which income is not recognized until cash or other payment is actually received and expenses are not taken into account until they are actually paid. This method is used in determining profitability because it most accurately reflects the true financial picture of a farming operation. Currently the tax code (Internal Revenue Code Section 446) recognizes that to require a separate method of accounting solely for calculating income tax liability is an unnecessary burden and states that income tax liability "shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." Section 446 goes on to specifically provide that the cash method is a permissible method of calculating tax liability.

Many taxpayers today, especially small businesses, find complying with the Internal Revenue Code burdensome. The cost of tax compliance for small businesses is 67% higher than that of a large business according to the National Federation of Independent Business. Agriculture is an industry that would be negatively impacted by the proposed changes to require accrual basis accounting. Farms, regardless of acreage, are perfect examples of small businesses. The definition of a small farm has changed dramatically due to advances in science and technology. According to the USDA, in 1945, 100 bushels of corn was produced on 2 acres of land. In 2002, that same 100 bushels of corn were produced on less than 1 acre. As you can see, fewer farmers produce more food on less acreage meaning many family farms may have larger gross revenue but not necessarily larger profits. The gross receipts thresholds proposed for accrual accounting would increase the cost of a family farm's compliance burden in an industry that is facing ever increasing input costs each year. Our nation may see further rises in our food prices passed along to the consumer by these growers.

Why cash accounting? Cash accounting is a simple method of record keeping. As illustrated in its most simple and basic definition, the differences between cash versus accrual accounting is a matter of timing. For example, if Farmer Brown sold a bushel of corn in November with the understanding that he would be paid in January, under the cash method, Farmer Brown would record the payment in January when he received payment from his customer. Any expenses associated with growing and preparing the corn for market would be recorded when Farmer Brown paid his suppliers. This method is not dissimilar to maintaining and reconciling a simple checking account.

Most farmers do not employ professional accountants or bookkeeping staff. Many farming operations are in rural communities that do not have a large population from which to draw high level CFOs, controllers or even accountants. Many farms' books and records are maintained by a family member or the farms' owners themselves. They are already saddled with the burden of hiring professionals to prepare payroll and tax returns as well as financial statements. Requiring them to switch to accrual basis would force them to hire bookkeeping assistance and/or spend additional funds on accrual accounting systems, thus creating additional costs in an industry facing rapidly rising production expenses. The simplicity of the cash accounting method can also offer a ready window into tracking cash on hand and current profitability. One story I would like to share with you reflects the financial strain accrual accounting can put on farms. One of our farm clients was being asked by his financial institution to provide accrual basis financial statements on a quarterly basis. As with most farms, they keep their records on the cash basis. After explaining the additional fees the farmer would incur to have us assist their staff in converting the books to accrual basis it was agreed that cash basis statements were a better option.

Farmers by nature must manage risk and volatility. It's endemic to their industry. They are literally at the mercy of nature, the effects and aftermath of weather, and commodity prices. "Whether caused by unpredictable weather that affects crop yields or uncontrollable markets that set the price of goods sold, it is not uncommon for farmers and ranchers to have years with little or no taxable income," Farm Bureau wrote to Senate Finance Committee Chairman Max Baucus (D-Mont.) and Ranking Member Orrin Hatch (R-Utah). Since their income can fluctuate widely from year to year, accrual accounting, coupled with our progressive tax system, would likely cause farmers to pay more taxes over time than a company in a different industry with stable income over the same time period. Cash accounting allows them to accelerate expenses or defer income giving farms the option to even out their taxable income comparable with long-term earnings of other industries. This also gives them the ability to plan for capital investments and the large purchases of inputs based on improved cash flow without incurring debt.

Most farmers and ranchers consider themselves to be small operations. Their operations are often divided into multiple businesses where some family members operate the farm while other family members may operate a related business, such as a processing facility or a retail market. Often times the farm may not have high gross receipts compared to the related business. Some proposals would decrease the threshold for switching to accrual accounting from $25 million to $10 million of gross receipts for C corporations and would also apply to S corporations, partnerships and sole-proprietorships that currently do not have a gross receipts limitation. Under the aggregation rules, the related businesses under common control would be combined. When combined, each of these related businesses, including the farm, would be required to use the accrual method of accounting. Most farms are structured as S corporations, partnerships or sole-proprietorships and would be subject to accrual accounting under these proposals. It may also be argued that the transition from the cash to the accrual method of accounting may be unfair to current owners of an enterprise if the switch to accrual penalizes current owners and compels them to pay for the benefits received by a previous owner.

As stated previously, the differences between cash versus accrual accounting is a matter of timing. Using the same scenario, if Farmer Brown sold a bushel of corn in November with the understanding that he would be paid in January, under the accrual method, Farmer Brown would record the income on his November books even though he's received no money. Farmer Brown also would incur the tax liability on this income even though he's received no money. Though receivables are definitely an asset that is an important measure in determining financial posture, only cash – and not receivables – can be used to pay income tax.

An independent research firm, Informa Economics, revealed that U.S. agricultural producers required to switch from cash-basis to accrual-basis accounting under proposed new laws would have to pay out as much as $4.84 billion in taxes during the next four years. Additionally, borrowing capacity of these operations would decrease by another $7.26 billion over the same time period. According to the study, these farms have less than $1.4 billion in current cash on hand to pay the additional taxes. If the tax proposals associated with cash accounting are effective in an unprofitable farm year or if growers cannot otherwise meet the capital requirements, the farmer may have to downsize to survive. Over 24 million people, or 17% of the US work force, are employed in agriculture industries. The estimated $4.84 billion in tax that would be required to be paid by farms could very easily limit the ability of those farms to hire additional employees or may cause them to lay off employees if they are forced to downsize.

We have many clients that are required to use accrual basis accounting for various reason in the Internal Revenue Code. As I mentioned in my introduction, I also have expertise in the construction industry. I have many examples of clients in this industry that have felt the challenges and burdens of accrual basis accounting. Especially in today's economy, many contractors are experiencing the pains of spending much of their time and effort collecting accounts receivable and managing related cash flow instead of growing their business or building buildings and homes. Many contractors may not receive payment until well after they have invoiced their customers and recorded the income under the accrual method of accounting. Often times, they may be filing tax returns and paying tax on those receivables before the cash has been collected. In a recent experience, a small contractor who I work with has been faced with extending his tax return for several years in a row and incurring penalties and interest until he was able to collect the receivables needed to pay his income taxes. Under the cash basis of accounting, these hardships are less likely to happen since the taxpayer would not pay income tax on the money until it was received.

<u>**Summary**</u>

The proposed requirement that farm operations use the accrual accounting method for tax purposes introduces complexity and expense to an industry that is already hobbled by gross receipts that do not necessarily indicate an increase in profitability. Producers operate at very low margins, usually under 20%.

After many years in public practice, I believe that the proposals that would require farm operations to use accrual accounting would be detrimental to the food producers whom it will affect and impact. Under these proposals no additional cash would be available to make tax payments – cash that would otherwise be used to grow business, create more jobs and serve the communities in which businesses operate.

In addition to being a CPA, I am the mother of two small children. The $4.84 billion in taxes that I referenced earlier from the projection made by the independent research firm, Informa Economics, reminds me of the fable I have read to my children - The Goose that Laid the Golden Egg. $4.84 billion dollars is, indeed, a golden egg. Unfortunately, in its pursuit, the forced switch to accrual-basis accounting may kill or do irreparable harm to the very enterprise that feeds the U.S. and the world. Golden eggs can be replaced. The goose, once dead, is gone.

Thank you for allowing me to testify today. I would like to thank Chairman Rice and the other members of the committee who have supported opposing limitations to the use of cash basis accounting. I would be delighted to address any questions from any Member of the Committee or your staff today. I, and others at Dixon Hughes Goodman LLP, would be pleased to address any further questions with you at any future date.