

## Grant Financial Management Requirement

The Department of Justice requires all recipients of federal awards to establish and maintain adequate financial records and accurately account for the funds received. In order to accurately maintain and track federal funds, organizations must follow the appropriate accounting practices as required by law. Per the Internal Revenue Service (IRS) [Publication 538 \(01/2019\), Accounting Periods and Methods](#), “Each taxpayer must use a consistent accounting method...”

### Important Information to Know

If an organization lacks the appropriate accounting methods, it would be difficult to determine the accurate taxes needed to pay the IRS or the annual revenue and expenses for the organization. To properly manage their finances, organizations should follow one of the accounting methods that clearly reflects their income and expenses. Accounting methods are the regulations organizations follow for reporting revenues and expenses.

#### What are the types of accounting methods?

There are two primary methods of accounting—cash method and accrual method. The alternative bookkeeping method is a modified accrual method, which is a combination of the two primary methods.

**Cash method**—income is recorded when it is received, and expenses are recorded when they are paid.

**Accrual method**—income is recorded when it is earned, and expenses are recorded when they are incurred.

**Modified accrual method**—income is recorded both when it is earned and when it is received, and expenses are recorded when they are incurred.

Smaller organizations typically use cash accounting as they do not produce, purchase, or sell merchandise. If an organization makes more than \$25 million in sales for three years or has inventory, the IRS requires that it use the accrual method of accounting. An organization must stay with its chosen accounting method, unless it receives approval from the IRS.

### Examples of cash method vs. accrual method

**Neighborhood Pathway sold 25 tickets for an annual gala to Community Trust Corp at a cost of \$2,500. The tickets were sold in February and Community Trust Corp paid its balance in March.**

#### Cash Method

The \$2,500 will not be recorded in the books until March, since the customer did not provide the cash or check until that time. Cash is recorded when it is received.

#### Accrual Method

The \$2,500 is recorded in February, even though the cash or check was not received until March. Revenue is recorded when the sale is made, not when the money is received.

#### Can an entity change its method of accounting?

An entity can change its method of accounting. But, if the entity is required to file a tax return with the IRS, it must have IRS approval.

## Which accounting method is appropriate for your entity?

It is best to consult with a tax professional or Certified Public Accountant on the most appropriate accounting method for your entity. Consider the following:

- ▶ The cash method is the easiest to use; however, because it does not record payables and receivables, it does not provide an accurate financial picture. Additional factors to consider:
  - ◆ If you have paid staff, you should not use the cash method of accounting.
  - ◆ Some states require the accrual method of accounting to be used, therefore, you should check your state regulations.
  - ◆ The cash method of accounting is best used by very small nonprofits with no paid staff, no set programs, and little to no plans for expansion.
- ▶ The accrual method provides an accurate report on how much money is earned and how much is spent. Additional factors to consider:
  - ◆ The accrual method of accounting should be used by organizations starting out with larger amounts of funding, paid staff, and plans to raise additional funds from larger donors.
  - ◆ It adheres to the Generally Accepted Accounting Principles (GAAP).
  - ◆ It requires a more complex accounting system than the cash method.
  - ◆ If you want an audit done under GAAP, you should use the accrual method of accounting.
- ▶ The modified accrual method works well when inventory is accounted for using the accrual method, and the cash method is used for recording income and expenses.
  - ◆ This method does not adhere to GAAP.

## How This Applies to Your Grant

Recipients of federal awards are required to submit the SF-425 Federal Financial Report. Per the [DOJ Grants Financial Guide](#), recipients must indicate, on their SF-425, if their accounting system operates a cash or accrual accounting system for reporting. Failure to submit an accurate SF-425 can result in an automatic hold being placed on the remaining federal funds awarded, and any payments requests that are submitted through the Automated Standard Application for Payments (ASAP) will be denied. If a recipient does not have their reports current, adjustments to current awards can be affected and restrictions can be placed on any new award.

For accounting methods, it is important to maintain solid accounting procedures, document every step of spending, build-in fail-safe procedures (internal controls), and develop and follow a budget.

## References

- Chen, J. (2020, November 6). Cash accounting. Investopedia. <https://www.investopedia.com/terms/c/cashaccounting.asp>
- Hayes, A. (2020, April 1). Accrual accounting. Investopedia. <https://www.investopedia.com/terms/a/accrualaccounting.asp>
- IRS. (2019, January). Publication 538 (01/2019), accounting periods and methods. <https://www.irs.gov/publications/p538>

## About the OJP Territories Financial Support Center

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