

## **Prepays Present Accounting Predicament**

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If you are like many oilheat retailers, you have signed up a certain percentage of your customers to price protection programs for the coming season. And it is likely that you have a number of customers who have actually prepaid for their oil in order to take advantage of pre-season pricing. In both cases you have collected money from your customers (price program fees or pre-payment for product and budget payments) without actually delivering anything.

That could be a problem. Accepting up front money is accounting problem that, if not handled properly, could come back to bite you in the wallet.

It all depends on whether your company is on the cash basis of accounting or the accrual basis. Put simply, the cash basis means that revenue is recognized when money is received from customers and expenses are recognized when money is paid out. But the accrual basis means revenue is only recognized when earned – when product is delivered or services performed. Expenses are then recognized when incurred (on your accounts payable list).

What this means is that prepaid accounts and budget credit balances are not recognized as income to companies on the accrual method. Not until you actually deliver the goods.

However, those swelling prepaid and budget accounts *are* recognized as income right away to companies using the cash method. And that means that you are going to be taxed on them right away.

Some will argue that these funds are not income until it is actually earned. But that is the whole point of the cash method: When you get the cash, it is income.

(If your company elected accrual method or applied for a “mixed method” of accounting when you first started in business, you are probably exempt from the problem. However, the “mixed method” election is unlikely, as somebody would have had to have been very forward thinking at the time of incorporation.)

For this reason, most oilheat companies should be on the accrual method of accounting. In fact, if your business is an “S” corporation and has sales in excess of \$10,000,000 over three years, you are required to switch to the accrual method.

For the cash basis taxpayer all is not lost. The company can apply for a “change in method.” The change in method from cash method to accrual method would more than likely be approved. If the change is approved, any effect of the change (income or deduction) would be allowed to be recognized over four years (25% per year).

As you can see this is not a simple issue. Certainly not as simply and clear-cut as was first believed. The IRS has the upper hand. A proactive response on your part is recommended versus waiting for the IRS to pay you a visit. Once the issue gains some attention (in the form of tax revenue), all the IRS has to do is review their data base for oil companies on the cash basis and they will have a list of which companies to audit.

This is not an issue that you can ignore. Please contact an experienced tax professional for help in resolving this problem and making alternate plans for future years.

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