A Cruel Accrual World

written by HOWARD SHWIFF

A little-used QuickBooks report can help you better understand your cash flow.

Here is my definition of "accrual": shifting financial events in time. For most property owners, accrual is a mid-winter virus that strikes on December 31. Accrual is spread by contact with rent checks and credit cards and other carriers identified by the IRS Center for Taxation Control (better known as the ITC or "Itsy"), and it usually results in confusion and hallucinations of time shifting, as if you're in a time warp.

For example, let's say you have accidental contact with a tenant's check for January's rent that you received before the end of the year. That rent payment for next year morphs into income for this year, and you get to pay tax on it 12 months earlier than you would have otherwise. On the other hand, contact with and extensive use of a credit card before December 31 can bring on a euphoric experience. Even though you don't actually pay for the charges until well into the next year, you get to accrue and time shift the charges into this year's tax deductions, as long as you can explain why that Santa Claus costume was a valid business expense.

Around March, your accountant creates the K-1s for you and your partners, and it shows everyone made some taxable income. Then your partners, probably a brother or cousins you never hear from otherwise, call and say, "What's going on? I didn't receive a distribution check all year long. And now you tell me I've got to pay taxes! On what? How'd that happen?"

Well, this is when it's time to familiarize yourself with a report that's always there in QuickBooks, though nobody ever looks at it. It's called the statement of cash flow, or the sources and uses statement. It's a wonderful little report that pulls it all together and is woefully underutilized.

The only report you usually look at, the profit and loss statement, shows you the income and the expenses. These lines then boil down to a net operating income. (I wonder who named it the profit and loss statement. Anyone ever seen one that showed both profit and loss?)

So, your partners say, "See, there *was* net income. So, where's my share?" And your accountant says to send them the balance sheet that clearly shows (in his accrual world) that their capital account balance has gone up—or down. It doesn't really matter, as there was no actual cash to distribute.

And that's when it's time to whip out the accrual-histamine bottle and give everyone a cash flow statement to cure all their ills. A cash flow statement is the linking statement that alleviates many issues by providing the link between the income statement and the balance sheet. It corrals all the cruel accruals into little compartments and shows where the cash actually went. It shows where the property generated cash and where the owners used the cash. It shows increases and decreases in payables; it shows increases and decreases in debt. It clarifies all of the sources of cash and the uses of cash.

For example, higher rents on leases may not translate into higher cash flow if the rents aren't collected and the accounts receivable increase. Poor tenant screening or poor rent collection may cause accrued increases in receivables and write offs. Furthermore, cash may be used to remodel apartments or purchase new appliances. Cash got spent, but due to a cruel accrual requirement, the appliance purchases cannot be fully expensed. Your profit and loss statement and tax return show just a dribble called depreciation expense.

On the cash flow statement, these cash events are grouped into three segments: cash flow from day-to-day operating activities (like rents which are a "source," and utilities, maintenance and repairs, etc, which are "uses"); cash flow from investment activities (uses like spending on those new appliances, new roof, or other investments to help increase rents and property value.); and cash flow from financing activities (like a use to pay down the mortgage, or a source borrowing on a new line of credit). Rather surprisingly, distribution to owners is grouped in financing activities. Distributions are the most desired use of cash, and distributions are grouped in financing activities because they represent the return on investment.

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The bottom line on the statement of cash flows is the net change in cash, which is the aggregate of the cash flows (sources and uses) from all of the operating, investing and financing activities. The property ownership entity started the year with an amount of cash, it ended the year with a different amount of cash, and we finally have a way to see what the sources were and what the uses were, despite living in the Itsy IRS's cruel accrual world. "Sources and Uses" captures all cash movements in a world of "cash only" transactions.

Hopefully there is a substantial increase in cash over the year (or whatever period the report covers). Then the strategic decision becomes: is it "free cash flow" for distribution, or does it represent funds that must be held and earmarked to invest in the property? Management has some discretion over how to use free cash flow. (Partners want to have some say also.) The lifestyle of some property owners depends on distributable free cash flow, so its importance should not be underestimated. But in some years cash must be invested back into the property to upgrade conditions and increase rents, or to strategically position a property for sale.

In conclusion, the cash flow statement is a beautiful link between the income statement and the balance sheet. The cash flow statement can help you understand (and explain to partners) where cash is going and where it came from. It summarizes your priority decisions to use cash to distribute and live on or to invest for increasing the value of your property. And it elevates you out of accrual world.

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