Guide 17

Accounting Methods and Recordkeeping

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Introduction

This guide outlines the rules and regulations for accounting and keeping records for tax purposes.

Accounting method

An accounting method is a set of rules used to determine when and how income and expenses are reported. There are two basic accounting methods: cash and accrual.

Cash method. Under the cash method, you report income in the tax year when received. You usually deduct or capitalize expenses in the tax year you pay them. Individuals (natural persons) will generally use the cash method of accounting.

Accrual method. Under an accrual method, you report income in the tax year in which you earn it, even though you may receive payment in another year. You deduct or capitalize expenses in the tax year you incur them, whether or not you pay them in that year. Corporations and Limited Liability Companies are required to use the accrual method of accounting.

Example 1: You run a carpet shop and sell a carpet for AFN 5,000 on 29 Hut 1388, but receive payment for the carpet on 6 Hamal 1389. Under the cash method of accounting, you would record the income in 1389, when you physically received it. Under the accrual method of accounting, you would record the income in 1388, when the sale occurred.

Example 2: You own a rental property. You received an advance rental payment of AFN 300,000 on 28 Aqrab 1388 for the period of 1 Qaus 1388 through 30 Jowza 1389 (six months). Under the cash method of accounting, you would record the income in 1388, the year you received it. Under the accrual method of accounting, you would report AFN 150,000 in 1388 and AFN 150,000 in 1389, when the rental services were provided.

Note

There are no fees or charges payable to the Ministry of Finance or its Revenue Department for any Tax Guides or Forms or at any stage of the tax assessment, collection or enforcement processes.

Note

The Income Tax Law 2009 provides for a penalty if a taxpayer fails to submit a tax return. This applies even if no tax is due for the period covered by the return. To avoid being penalized, taxpayers therefore should submit returns even if no tax is due and state on the return that none is due.

Individuals, partnerships, and other taxpayers who are able to, may and should use the accrual method of accounting. To do so, the taxpayer must request permission, in writing, from the Ministry of Finance no later than 30 days before the end of the taxable year.

If a change to an accrual method of accounting is approved, the taxpayer must record income when 'booked' rather than received, while deducting expenses incurred in prior years but not paid. These adjustments are reported for the last year in which the cash method of accounting was used.

Example: An importer who, in the year 1387, has taxable income of AFN 150,000 computed under the cash method of accounting, has obtained permission to report his income for the next taxable year (1388) as computed by using accrual method of accounting. Before he files his 1388 return on the accrual basis he will have to file an amended 1387 return to adjust and account for transactions up to the beginning of 1388.

Assuming that at the time of setting up his new accounting system at the beginning of the year 1388, his beginning balance sheet shows the following assets and liabilities:

Assets:		Liabilities:	
Accounts Receivable	60,000	Unpaid Purchase	32,000
Accrued Interest on Notes Receivable	6,000	Accrued Interest Expense	3,000
Prepaid Insurance	7,000	Accrued Rental Expense	1,500
		Unpaid Wages of Employees	7,500

The amended return that will have to be filed is as follows:

a. Taxable income for 1387 year	*150,000*
b. Add income earned but not received:	
1. Accounts receivable	*60,000*
2. Accrued interest receivable	*6,000*
Total income not received	*66,000*
c. Total income earned and received ((a) + (b) above)	*216,000*
d. Add expenses paid and deducted but not yet incurred:	
Prepaid insurance	*7,000*
e. Total items (c) and (d)	*223,000*
f. Less accounts payable:	
1. Purchase not paid for	*32,000*
2. Accrued interest expense	*3,000*
3. Accrued rental expense	*1,500*
4. Unpaid wages	*7,500*
Total accounts payable	*44,000*
g. Taxable income as amended ((e) less (f) above)	*179,000*
h. Total tax per amended return (179,000 x 20%)	*35,800*
i. Income tax paid per original return	*30,000*
j. Additional tax due	*5,800*

Any additional tax due to the change in the accounting period or methods must be paid with the amended return. Any reduction in tax computed according to an amended return filed in connection with the same changeover shall be subtracted from any income tax owing on income of a subsequent year.

Example: An amended return for the year 1387 is filed together with the first return on accrual method for the year 1388 in Sonbula 1389. Any additional tax computed in the amended return is due at that time, and no interest or *penalty is charged if this tax is paid before the end of the third month of 1389. Any reduction in tax indicated by the amended return may be subtracted from the 1388 tax or, if no tax is due from 1388, or if the tax due is less than the reduction, it can be deducted from due taxes for subsequent years.*

Recordkeeping

According to the Income Tax Law 2009, all businesses must keep adequate records to verify income and expenses for tax purposes.

The Income Tax Law 2009 provides for 'self assessment' of taxes due: the taxpayer determines the amount due based on the Law as applied to a business. The key to paying only taxes due is accuracy, and accuracy, in turn, depends upon good records and good record keeping practices. In addition to complying with the law, good records will help you do the following:

Monitor the progress of your business. Good records provide useful data regarding cost control, inventory turnover, profit on products and/or services sold, leading to informed business decisions, increased profitability and long term success.

Prepare your financial statements. Good records can help you to prepare accurate financial statements. These include income (profit and loss) statements and balance sheets. These statements can help you in dealing with your bank or creditors.

- An *income statement* shows income and expenses for a business for a given time period.
- A *balance sheet* shows assets, liabilities, and equity in a business on as of a given date.

Identify source of receipts. Receipts are both a means to identify source of income important for management of accounts as well as proof of transactions. Such proof is important for your self assessment of tax obligations and reporting. The better the records, the quicker the task, and the less worry should you be asked to verify deductions taken. For these reasons, you should always separate business from non-business receipts.

Example: You run a restaurant and also sell souvenirs through the restaurant. Only the receipts from the sale of food and beverages are subject to the 10% business receipts tax on services. The receipts from the sale of souvenirs are only subject to 2% business receipts tax and then only if your business is registered as a legal person. Good recordkeeping will help you keep the two types of sales separate.

Record deductible expenses as they occur. Forgetting to deduct expenses effectively inflates net income and adds erroneously to income tax due. In addition, expenses cannot be deducted if appropriate records are not available to verify the deduction amount.

Prepare your tax declarations. Good records will support the income, expenses, and credits you report. If you do not keep accurate records, the Afghanistan Revenue Department may make an arbitrary tax assessment based on observations of your business or may require you to pay a fixed tax in lieu of income tax. While these may be easier options, they will usually result in a much higher tax liability as no allowance for expenses is given.

Kinds of records to keep The law does not require any specific kind of records. You should choose a recordkeeping system that best suits your business and that clearly shows your income and expenses. If you are in more than one business, you should keep a complete and separate set of records for each business.

Supporting documents

Gross receipts show the income you receive from your business. You should keep supporting documents that show the amounts and sources of your gross receipts. Documents that show gross receipts include, but are not limited to:

- Cash register tapes
- Bank deposit slips
- Receipt books
- Invoices

Purchases are the items you buy and resell to customers. If you are a manufacturer or producer, purchases include the cost of raw materials or parts used for manufacture into finished products. If you are a wholesale or retail establishment, purchases are the actual products that you buy for resale. If you are a restaurant, café, or a food or beverage merchant, this includes the cost of foodstuffs used in preparing the finished product. Your supporting documents should show the amount paid and that the amount was for purchases. These records will help you to determine the value of your inventory at the end of the year. Documents for purchases include the following:

- Cash register tape receipts
- Invoices
- Sales slips

Expenses are the ordinary and necessary costs you incur (other than purchases) to conduct your business. Your supporting documents should show the amount you paid and that the amount was for a business expense. Documents for expenses include the following:

- Cash register tape receipts
- Invoices
- Sales slips
- Account statements

Assets are the property, such as machinery and furniture, you own and use in your business. You must keep records

1) to verify certain information about your business assets
2) to calculate annual depreciation and gain or loss when you sell the assets. Your records should show the following information:

- When and how you acquired the asset
- Purchase price
- Cost of any improvements
- Deductions taken for depreciation
- How you used the asset
- When and how you disposed of the asset
- Selling price

The following documents may show this information:

- Purchase and sales invoices
- Real estate closing/transfer statements
- Registration documents

Recording business transactions

A good recordkeeping system includes a summary of your business transactions supported by the documents just discussed. Business transactions are usually recorded in books called journals and ledgers, available in stationery shops and office supply stores. Often businesses will keep such records in an electronic format. Whether kept as a physical book or in electronic format, the functions are the same. Similarly, you are required to present your records to ARD auditors upon request, whatever the format- manual or electronic.
A *journal* is a book where you record each business transaction shown on your supporting documents.

A *ledger* is a book that contains the totals from all of your journals. It is organized into different accounts.

What records to keep and how depends upon your type of business. For example, a recordkeeping system for a small retail business may include the following:

- Daily summary of cash receipts
- Monthly summary of cash receipts
- Cash payments journal
- Depreciation worksheet
- Employee payroll record

Note

A new website, http://www.ard.gov.af, makes it easy for taxpayers to find and download useful information to meet their needs. Here the taxpayer can find the Income Tax Law 2009, various public announcements and rulings, forms, along with instructions for completing same, guides, archived documents, Questions & Answers regarding wage withholding tax, and other references including an Income Tax Manual. The manual discusses separately each article of the law, along with relevant regulations, often with helpful examples.

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