Professional Education Services, LP

Tax-Basis Financial Statements

#7345A

COURSE MATERIAL

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TABLE OF CONTENTS

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TAX-BASIS FINANCIAL STATEMENTS

Course Objectives

After completing this course, you should be able to:

- Recognize some of the M-1 differences that do not apply to tax-basis financial statements.
- Recognize how to account for an accounting change in tax-basis financial statements.
- Recall how to account for and present nontaxable and nondeductible items in tax-basis financial statements.
- Identify the disclosure requirements for tax-basis financial statements.
- Recognize the appropriate and inappropriate financial statement titles for tax-basis financial statements.

Given the wave of complexity that has affected the accounting profession over the past decade, using tax-basis[1] financial statements has become increasingly popular with nonpublic businesses.

More than ever, major differences now exist between GAAP and taxable income due to two factors. First, there has been a continued upheaval in the tax code since the mid-1980s. Second, the FASB has issued numerous GAAP statements in the post-Enron period.

As a result, small business owners find a continued conflict between balancing a desired lower taxable income for tax planning with higher financial statement income necessary to appease the bank or third party investor. In certain cases, tax-basis statements act to bridge this gap so that tax and financial income are more congruous.

A. DEFINITION OF SPECIAL PURPOSE FRAMEWORK AND TAX BASIS

Before the author continues in this section, the term "income tax basis" is a term that was in effect prior to 2012. From 2012, that term is replaced with the new term "tax basis" based on newly issued auditing, compilation and review standards.

Oddly enough, the rules for non-GAAP frameworks, such as income tax basis, have existed within auditing literature since inception. SAS No. 62, *Special Reports*, originally introduced the concept of other comprehensive basis of accounting (OCBOA), a term that has included income tax basis, cash/modified cash basis, and regulatory basis of accounting. Parallel guidance was included with the SSARSs.

Effective 2012, the Auditing Standards Board (ASB) reissued all auditing standards under its Clarity Project. In doing so, the ASB issued SAS Nos. 122-126, which was subsequently supplemented by SAS Nos. 127 and 128.

1. The previous term "income tax basis" is superseded by the term "tax basis" under new auditing, compilation, and review standards.

As part of the reissuance of the SASs, the guidance found in SAS No. 62, *Special Reports*, was superseded by new AU-C 800: *Special Considerations- Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*. AU-C 800 introduces a new term "special purpose framework," which encompasses non-GAAP frameworks used to issue financial statements. In essence, the special purpose framework concept replaces other comprehensive basis of accounting (OCBOA) that has been used to define non-GAAP frameworks such as income tax-basis financial statements. One key change made is that the term "income tax basis" is replaced with the term "tax basis."

In October 2014, the AICPA's Accounting and Review Services Committee (ARSC) completed its own Clarity Project to recodify the compilation and review standards, by issuing SSARS No. 21, *Statements on Standards for Accounting and Review Services: Clarification and Recodification*. SSARS No. 21 supersedes all compilation and review standards found in SSARS No. 19 and other SSARSs (except one) and is effective for years ending on or after December 15, 2015. Early application is permitted.

SSARS No. 21 encompasses new standards for compilation and review engagements, and introduces a newly authorized "preparation of financial statements" engagement found in AR-C Section 70 of SSARS No. 21.

A key change made by SSARS No. 21 is that it carries over the new definition of "special purpose framework" (and the new "tax basis" term) found in auditing standards within AU-C 800.

Thus, after the effective dates of AU-C 800 (auditing standards) and SSARS No. 21 (compilation and review standards), there is a new set of rules that apply to "tax-basis" financial statements under the concept of a special purpose framework. Those rules and definitions are consistent across the board for auditing, review and compilation engagements, as well as the newly authorized preparation of financial statements engagement.

B. NEW DEFINITION OF TAX-BASIS FINANCIAL STATEMENTS

AU-C 800 (auditing standards) and SSARS No. 21 (compilation and review standards), introduce the new term "special purpose framework" to encompass certain "non-GAAP" frameworks.

AU-C 800 and SSARS No. 21 define a *special purpose framework* as a financial reporting framework other than GAAP that is one of the following bases of accounting:

- **Cash basis:** A basis of accounting that the entity uses to record cash receipts and disbursements and modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets).

- **Tax basis:** A basis of accounting that the entity uses to file its income tax return for the period covered by the financial statements. Tax basis can include cash basis, accrual basis, or any method that clearly reflects income under Section 446 of the Internal Revenue Code.

- **Regulatory basis:** A basis of accounting that the entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject (for example, a basis of accounting that insurance companies use pursuant to the accounting practices prescribed or permitted by a state insurance commission.)
- **Contractual basis:** A basis of accounting that the entity uses to comply with an agreement between the entity and one or more third parties other than the auditor.
- **Other basis:** A basis of accounting that uses a definite set of logical, reasonable criteria that is applied to all material items appearing in financial statements.

The cash, tax, regulatory and other bases of accounting have been commonly referred to as *other comprehensive bases of accounting*, although the term "OCBOA" is no longer included in any of the standards.

The following table compares the new definition of special purpose framework to the version of OCBOA previously found in old SAS No. 62, *Special Reports*.

	New Definition Special Purpose Framework AU-C 800 and SSARS No. 21	Previous Definition Other Comprehensive Basis of Accounting (OCBOA) (SAS No. 62, AU 523)
Definition	Special Purpose Framework	Other Comprehensive Basis of Accounting (OCBOA)
Cash basis	A basis of accounting that the entity uses to record cash receipts and disbursements and modifications of the cash basis having substantial support	The cash receipts and disbursements basis of accounting, and modifications of the cash basis having substantial support
Tax basis (Income tax basis)	*Tax basis*: A basis of accounting that the entity uses to file its income tax return for the period covered by the financial statements	*Income tax basis*: A basis of accounting that the reporting entity uses or *expects to use* to file its income tax return for the period covered by the financial statements

	New Definition Special Purpose Framework AU-C 800 and SSARS No. 21	Previous Definition Other Comprehensive Basis of Accounting (OCBOA) (SAS No. 62, AU 523)
Regulatory basis	A basis of accounting that the entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject	A basis of accounting that the reporting entity uses to comply with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject
Contractual basis	A basis of accounting that the entity uses to comply with an agreement between the entity and one or more third parties other than the auditor	Previously permitted by SAS No. 62 but not defined
Set of criteria that have substantial support	NA- not included under the new definition of Special Purpose Framework	A definite set of criteria *having substantial support* that is applied to all material items appearing in financial statements, such as the price-level basis of accounting
Other basis of accounting	A basis of accounting that uses a definite set of *logical, reasonable criteria* that is applied to all material items appearing in financial statements	NA- not included in previous SAS No. 62 definition

Observation

Under AU-C 800, the term *OCBOA* is replaced with the term *special purpose framework*. Previously, the definition of other comprehensive basis of accounting (OBCOA) included any set of criteria that had substantial support. The new SAS does not include, under the definition of special purpose framework, any set of criteria having substantial support.

Observation (continued)

Further, the definition of "tax basis" is changed slightly from the previous "income tax basis" one found in SAS No. 62. The SAS No. 62 definition of income tax basis was "a basis of accounting that the reporting entity "uses" or *"expects to use"* to file its income tax return for the period covered by the financial statements." The new definition removes "expects to use" from the definition. As a practical matter, eliminating "expects to use" from the definition should have no significant effect on its application.

Lastly, the term "income tax basis of accounting" has been replaced with the term "tax basis of accounting."

In this course, the author will focus solely on tax-basis financial statements, which is the basis of accounting used for income tax purposes.

Definition of Tax-Basis Statements

Both AU-C 800 and SSARS No. 21 define the tax basis as:

"A basis of accounting that the entity uses to file its income tax return for the period covered by the financial statements."

Implicit in the definition is that the tax basis is the basis of accounting based on the principles and rules for accounting under the [federal] income tax laws and regulations. However, there is nothing explicitly stated that tax basis must follow federal tax law. Instead, an entity could issue tax-basis financial statements based on other tax laws such as those promulgated by state and local government, provided the taxing authority is identified.

Observation

One of the advantages of tax-basis financial statements is that there are few accounting issues that need to be addressed. Assuming the federal tax basis is used, all transactions are accounted for in accordance with the Internal Revenue Code and its regulations.

C. WHEN TO USE AND NOT USE TAX-BASIS FINANCIAL STATEMENTS

Determining whether tax-basis financial statements are appropriate for a client to use requires overall consideration of several factors, including the ultimate use of the financial statements.

1. When to use tax-basis financial statements:

   Tax-basis financial statements are best used and most meaningful for a less financially sophisticated client where the client is more tax motivated and interested in cash flows. Further, it is helpful to have the owner who is actively involved in the day-to-day operations to ensure that the owner understands the real economics of the business. A third attribute is that the company should be strong financially so that it will not be forced into debt covenant violations by presenting a lower net income.

From both the client and CPA's perspective, a tax-basis engagement is generally less expensive to conduct. Overall audit, review or compilation procedures are generally less time consuming when preparing financial statements on the tax basis. Because revenue and expenses in tax-basis financial statements are based on the Internal Revenue Code, there are simply fewer items to audit, review or compile. For example, the allowance for uncollectible accounts is not present in tax-basis financial statements because bad debts are recorded on a direct write-off method. If the allowance is not present, the auditor or accountant eliminates the time needed to compute and test the allowance balance.

With tax-basis financial statements, all deferred M-1 items are eliminated, but permanent M-1s are still presented in tax-basis financial statements.

Following is a list of deferred M-1 items that are not applicable to tax-basis financial statements.

<u>Deferred M-1s Eliminated (Federal Tax Basis)</u>:

- One depreciation method
- No UNICAP difference
- No unrealized gains on securities- ASC 320 (formerly FASB No. 115)
- No related party accruals
- No vacation accruals
- No allowance for bad debts
- No impairment of assets issues
- No deferred income taxes
- No impairment of goodwill or amortization difference
- No consolidation of variable interest entities

In addition, a statement of cash flows is not required for tax-basis financial statements. ASC 230, *Statement of Cash Flows* (formerly FASB No. 95), requires a statement of cash flows only if GAAP statements are issued. However, a statement of cash flows may be included in tax-basis financial statements at the option of the company.

For not-for-profit organizations, tax-basis financial statements can be very effective at reducing overall engagement time. Specifically, those not-for-profits that wish to avoid the requirements of ASC 958 (formerly FASB Nos. 116 and 117) may do so using tax-basis financial statements. Consider the following short list of savings:

a) Donated services are not recorded.

b) Statement of cash flows is not required.

c) Statement of functional expenses and presentation of the amount of unrestricted, temporarily restricted and permanently restricted net assets are not required. The substance of this information may be presented in the notes or elsewhere.

2. When not to use tax-basis financial statements

Tax-basis financial statements should not be used in every situation. Generally, they should not be considered where the statements may be misleading. The author believes there are *two specific situations* in which the use of tax-basis financial statements could be considered misleading:

a) Not having an allowance for bad debts under the tax basis can be a significant problem for some companies with high uncollectibles.

b) Not recording a contingent liability under the tax basis where an entity has a large contingency for an environmental liability or litigation claim can distort the financial statements.

These two situations can be resolved by issuing tax-basis financial statements with a tax-basis departure for an allowance or an accrual for an environmental liability. Certainly, the client's intent must be considered in deciding whether to issue tax-basis statements.

D. PRESENT REPORTING AND DISCLOSURE AUTHORITY- TAX BASIS

1. At present, there is limited authority for tax-basis statements. The general authority is found as follows:

a) SAS No. 122, AU-C Section 800, *Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*.

b) SSARS No. 21, *Statements on Standards for Accounting and Review Services: Clarification and Recodification*

Even though two sets of standards provide the overall authority for using tax-basis financial statements, there is little guidance that addresses the practical application of tax-basis financial statements including overall financial statement format, specific disclosures that are required, and other matters such as how to handle certain permanent M-1 items.

E. ITEMS PECULIAR TO TAX-BASIS FINANCIAL STATEMENTS

Because there is minimal authoritative guidance related to tax-basis financial statements, certain transactions are generally accounted for in practice as follows:

1. Accounting changes for tax purposes: Treated in accordance with federal tax law, usually requiring a 481(a) adjustment spread prospectively over four years.

2. Nontaxable revenues and nondeductible expenses (permanent differences): These items are **included** in tax-basis statements, yet not included as part of taxable income.

Therefore, tax-basis income will not necessarily agree with taxable income per tax return (line 28 of Form 1120).

a) Example: 50% meals and entertainment, penalties, key man life insurance, and non-taxable interest income

b) There are generally *four ways* to present these items:

- As income and expense items on the tax-basis income statement
- As separate items on the income statement in the other income and expense section
- Adjustments through retained earnings
- Disclosure only

Note

The most common method in practice is to present the permanent M-1 items on the income statement in a separate section or through retained earnings.

M-1 shown on other income and expense section:

Statement of Income- Tax Basis

Net sales	$xx
Cost of sales	xx
Gross profit	xx
Operating expenses	xx
Net income before income taxes	xx
Income taxes	xx
Net income before non-taxable and non-deductible items	xx
Non-taxable and non-deductible items:	
Key-man life insurance	**(2,000)**
Non-taxable interest	**3,000**
Net income	xx

c) Taxable income adjustments for prior years' IRS or state audit:

- Treated on tax-basis statements as a prior-period adjustment, charged to retained earnings, net of taxes. If GAAP statements, only the tax effect would be adjusted.

Example: A Company is audited for 20X1 and the IRS capitalized $100,000 of expenditures that were charged to repairs and maintenance. The IRS and state tax assessment is $40,000. The company makes an entry to record the fixed assets and tax liability in 20X2.

Entry:

Fixed assets	100,000	
Retained earnings		100,000
Retained earnings	40,000	
Accrued taxes		40,000

Statement of Retained Earnings- Tax Basis- December 31, 20X2

Balance- beginning of year	XX
Net income- tax basis	XX
Prior period adjustment: Capitalization of expenditures previously expensed (net of tax effect of $40,000)	***60,000***
Balance- end of year	XX

Note

If GAAP statements were issued, the company would record the $40,000 tax effect only but not the fixed assets. Thus, the only entry to retained earnings would have been $40,000. Depending on materiality, the $40,000 might have to be adjusted through the current year income statement.

F. DISCLOSURE AND FINANCIAL STATEMENT REQUIREMENTS- TAX BASIS

AU-C 800 and SSARS No. 21 require that certain disclosures be included in tax-basis financial statements as follows:

1. A description of the special purpose framework (tax basis)
2. A summary of significant accounting policies
3. An adequate description about how the special purpose framework (tax basis) differs from GAAP. The effects of these differences need not be quantified
4. Informative disclosures similar to those required by GAAP when the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP.

Note

In the case of financial statements prepared in accordance with a contractual basis of accounting, the disclosures should adequately describe any significant interpretations of the contract on which the financial statements are based.

Fair Presentation and Adequate Disclosures- Tax Basis

When the special purpose financial statements contain items that are the *same as, or similar to*, those in financial statements prepared in accordance with GAAP, informative disclosures similar to those required by GAAP are necessary to achieve fair presentation.

1. If special purpose financial statements contain items for which GAAP would require disclosure, the financial statements may either:
    - Provide the relevant disclosure that would be required for those items in a GAAP presentation, or
    - Provide *qualitative information* that communicates the substance of that disclosure.

Notes

Note 1. Qualitative information may be substituted for quantitative information required by GAAP.

For example, GAAP requires disclosure of the future principal payments on long-term debt over the next five years. For tax-basis financial statements, this disclosure could be satisfied by merely disclosing the repayment terms of significant long-term borrowings without quantifying it in a schedule.

Note 2. Tax-basis financial statements should include the same GAAP disclosures provided they are relevant and applicable to the tax basis.

For example, a disclosure of unrealized gains on securities and actuarial disclosures for defined benefit pensions would not be relevant to tax-basis financial statements.

G. MAKING TAX-BASIS FINANCIAL STATEMENTS SIMPLER TO USE AND UNDERSTAND

The following represents a sample of financial statement formats that the author believes may be useful in applying tax-basis financial statements.

Example 1: Compilation Report- Tax Basis: Substantially All Disclosures Omitted (SSARS No. 21)

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheet- tax basis as of the year ended December 31, 20XX, and the related statement of income and retained earnings- tax basis, for the years then ended *in accordance with the tax-basis of accounting*, and for determining that the *tax-basis of accounting is an acceptable financial reporting framework.*[2] We have performed a compilation engagement in accordance with

2. AR-C 80 states that when special purpose framework financial statements are prepared and management has a choice of frameworks, the accountant's compilation report should reference management's responsibility for determining that the framework is acceptable.

Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. We did not audit or review the financial statements nor were we required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, we do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

The financial statements are prepared in accordance with the tax basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America.

Management has elected to omit substantially all the disclosures *ordinarily included*[3] in financial statements prepared in accordance with the tax basis of accounting. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the company's assets, liabilities, equity, revenue, and expenses. Accordingly, the financial statements are not designed for those who are not informed about such matters.

James J. Fox & Company CPA
Burlington, Massachusetts

March 20, 20X1

Observation

Notice that in the sample compilation report, the language "ordinarily included" has been used in lieu of the traditional language "Management has elected to omit substantially all disclosures and the statement of cash flows required by GAAP." The reason for this change in language is due to the fact that there is no authority as to which disclosures are specifically required by the tax-basis framework. Further, a statement of cash flows is not required for non-GAAP formats such as the tax basis, and therefore is not mentioned in this report.

3. The term "ordinarily included" is used when tax-basis financial statements are issued in lieu of the term "required" for GAAP statements.

Example 1: Balance Sheet- Tax Basis

XYZ Company
Balance Sheet- Tax Basis
December 31, 20XX

ASSETS	
Current assets:	
Cash	$200,000
Accounts receivable- trade	300,000
Inventories	450,000
Prepaid expenses	50,000
Total current assets	1,000,000
Plant and equipment:	
Cost	1,200,000
Less accumulated depreciation	500,000
Total plant and equipment	700,000
	$1,700,000
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current liabilities:	
Accounts payable	$300,000
Accrued expenses	100,000
Short-term note payable	500,000
Total current liabilities	900,000
Long-term debt:	700,000
Stockholders' equity:	
Common stock	100
Retained earnings	99,900
Total stockholders' equity	100,000
	$1,700,000

Example 1: Statement of Income and Retained Earnings- Tax Basis

Option 1: Income Statement- M-1 Items Shown in Separate Section on Income Statement

XYZ Company
Statement of Income and Retained Earnings- Tax Basis
For the Year Ended December 31, 20XX

Net sales	$1,000,000
Cost of sales- tax return	800,000
Gross profit	200,000
Deductible expenses:	
Officer's compensation	25,000
Salaries and wages	25,000
Utilities	10,000
Advertising and promotion	5,000
Insurance	2,000
Uncollectible accounts	21,000
Payroll taxes and fringe benefits	12,000
State excise taxes	5,000
Interest	18,000
Depreciation	20,000
Sundry other expenses	5,000
Total deductible expenses	148,000
Taxable state income	52,000
State income taxes	(5,000)
Taxable federal income	**47,000****
Non-taxable and non-deductible item:	
Federal income tax expense	(7,500)
Non-deductible life insurance	**(12,000)**
Nondeductible meals and entertainment	**(2,500)**
Non-taxable interest	**3,000**
Net income	28,000
Retained earnings:	
Beginning of year	71,900
End of year	$99,900

** Agrees with line 28 of tax return.

Example 1: Statement of Income and Retained Earnings- Tax Basis

Option 2: Income Statement- M-1 Items Shown as Adjustments to Retained Earnings

XYZ Company
Statement of Income and Retained Earnings- Tax Basis
For the Year Ended December 31, 20XX

Net sales	$1,000,000
Cost of sales- tax return	800,000
Gross profit	200,000
Deductible expenses:	
Officer's compensation	25,000
Salaries and wages	25,000
Utilities	10,000
Advertising and promotion	5,000
Insurance	2,000
Uncollectible accounts	21,000
Payroll taxes and fringe benefits	12,000
State excise taxes	5,000
Interest	18,000
Depreciation	20,000
Sundry other expenses	5,000
Total deductible expenses	148,000
Taxable state income	52,000
State income taxes	(5,000)
Taxable federal income	**47,000****
Retained earnings:	
Beginning of year	71,900
Non-taxable and non-deductible item:	
Federal income tax expense	(7,500)
Non-deductible life insurance	**(12,000)**
Non-deductible meals and entertainment	**(2,500)**
Non-taxable interest	**3,000**
End of year	$99,900

** Agrees with line 28 of tax return.

Example 1: Statement of Income- Tax Basis

Option 3: S Corporation

XYZ Company (An S Corporation)
Statement of Income- Tax Basis
For the Year Ended December 31, 20XX

Net sales	$1,000,000
Cost of sales- tax return	800,000
Gross profit	200,000
Deductible expenses:	
Officer's compensation	25,000
Salaries and wages	25,000
Utilities	10,000
Advertising and promotion	5,000
Insurance	2,000
Uncollectible accounts	21,000
Payroll taxes and fringe benefits	12,000
State excise taxes	5,000
Interest	18,000
Depreciation	20,000
Sundry other expenses	5,000
Total deductible expenses	148,000
Taxable ordinary income	**47,000****
Other taxable income (deductible expenses):	
Interest	1,000***
Dividends	5,000***
Additional depreciation deduction	(19,000)***
Total taxable income	34,000**
Non-taxable and non-deductible items:	
Non-deductible life insurance	**(12,000)**
Non-deductible meals and entertainment	**(2,500)**
Non-taxable interest	**3,000**
Net income	$22,500

** Agrees with Schedule K of Form 1120S

*** Schedule K items.

Example 2: Review Report (SSARS No. 21)

<u>Independent Accountant's Review Report</u>

Board of Directors
XYZ Company

We have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheet- tax basis as of December 31, 20XX, the related statements of income and retained earnings- tax basis, and the statement of cash flows- tax basis,[4] for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's financial data and making inquiries of management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statement as a whole. Accordingly, we do not express such an opinion.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the basis of accounting the company uses for income tax purposes; this includes determining that the basis of accounting the company uses for income tax purposes is an acceptable basis for the preparation of financial statements in the circumstances.[5] Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Accountant's Responsibility

Our responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants. Those standards require us to perform procedures to obtain limited assurance as a basis for reporting whether we are aware of any material modifications that should be made to the financial statements for them to be in accordance with the basis of accounting the company uses for income tax purposes. We believe that the results of our procedures provide a reasonable basis for our report.

4. A statement of cash flows is optional for non-GAAP frameworks such as a tax basis.
5. When management has a choice of financial reporting frameworks, AR-C 90 requires that the review report make reference to management's responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances.

Example 2: Review Report (SSARS No. 21) (continued)

Independent Accountant's Review Report (continued)

Accountant's Conclusion

Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be *in accordance with the basis of accounting the company uses for income tax purposes*.

Basis of Accounting[6]

We draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared in accordance with the basis of accounting the company uses for income tax purposes, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our conclusion is not modified with respect to this matter.

James J. Fox & Company, CPA
Burlington, Massachusetts
March 20, 20X1

6. When a special purpose framework report is issued, the review report must include an emphasis-of-matter paragraph labeled "Basis of Accounting" or a similar title.

Example 2: Balance Sheet- Tax Basis

XYZ Company	
Balance Sheet- Tax Basis	
December 31, 20XX	
ASSETS	
Current assets:	
Cash	$200,000
Accounts receivable- trade	300,000
Inventories	250,000
Prepaid expenses	150,000
Total current assets	900,000
Plant and equipment:	
Cost	1,150,000
Less accumulated depreciation	500,000
Total plant and equipment	650,000
Other assets:	
Agreement not to compete	$100,000
Investment in mutual funds	50,000
Total other assets	150,000
	$1,700,000
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current liabilities:	
Accounts payable	$700,000
Accrued expenses	200,000
Current portion of long-term debt	100,000
Total current liabilities	1,000,000
Long-term debt (net of current portion):	600,000
Stockholders' equity:	
Common stock	100
Retained earnings	99,900
Total stockholders' equity	100,000
	$1,700,000
See notes to financial statements	

Example 2: Statement of Income and Retained Earnings- Tax Basis

Income Statement- M-1 Items Shown in Separate Section on Income Statement

XYZ Company
Statement of Income and Retained Earnings- Tax Basis
For the Year Ended December 31, 20XX

Net sales	$1,192,000
Cost of sales- tax return	800,000
Gross profit	392,000
Deductible expenses:	
Officer's compensation	25,000
Salaries and wages	25,000
Utilities	10,000
Advertising and promotion	5,000
Insurance	2,000
Uncollectible accounts	21,000
Rent expense	94,000
Retirement plan expense	23,000
Payroll taxes and fringe benefits	12,000
State excise taxes	5,000
Amortization	10,000
Interest	18,000
Depreciation	85,000
Sundry other expenses	5,000
Total deductible expenses	340,000
Taxable state income	52,000
State income taxes	(5,000)
Taxable federal income	**47,000****
Non-taxable and non-deductible item:	
Federal income tax expense	(7,500)
Non-deductible life insurance	**(12,000)**
Non-deductible meals and entertainment	**(2,500)**
Non-taxable interest	**3,000**
Net income	28,000
Retained earnings:	
Beginning of year	71,900
End of year	$99,900

** Agrees with line 28 of tax return.

See notes to financial statements

Example 2: Statement of Cash Flows- Tax Basis

XYZ Company
Statement of Cash Flows- Tax Basis
For the Year Ended December 31, 20XX

Cash flow from operating activities:	
Net income	$28,000
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation and amortization	95,000
Change in trade receivables	100,000
Change in inventories	60,000
Change in accounts payable	(30,000)
Change in accrued expenses	(20,000)
Change in prepaid expenses	(10,000)
	223,000
Cash flows from investing activities:	
Purchases of equipment	(150,000)
	(150,000)
Cash flows from financial activities:	
Repayment of long-term debt	(100,000)
Decrease in cash and cash equivalents	(27,000)
Cash and cash equivalents:	
Beginning of year	227,000
End of year	$200,000
Supplementary cash flow disclosures:	
Interest paid	$18,000
Income taxes paid	12,500

See notes to financial statements.

Example 2: Notes to Financial Statements

XYZ Company
Notes to Financial Statements- Tax Basis
For the Year Ended December 31, 20XX

NOTE 1. NATURE OF OPERATIONS

The Company is a manufacturer of fine widgets used in the medical community. The Company has three retail outlets located in Notown, Everytown and Whichtown, Massachusetts. The majority of the company's sales are made to customers engaged in medical distribution within New England.

Note

The above disclosure satisfies the nature of business disclosure (ASC 275 (formerly SOP 94-6)) and the concentration of accounts receivable (ASC 825 (formerly 107)).

NOTE 2. BASIS OF ACCOUNTING

The accompanying financial statements present financial results on the accrual basis of accounting used for federal income tax purposes which ***differs*** from the accrual basis of accounting required under generally accepted accounting principles. The ***primary differences*** between the Company's method and the method required by generally accepted accounting principles are that: ***a) depreciation has been recorded using accelerated methods authorized in the Internal Revenue Code, b) uncollectible accounts on accounts receivable are recorded when deemed uncollectible without use of an allowance account, c) certain accruals for compensation and other expenses are recorded when paid rather than when incurred, and d) certain costs are capitalized to inventory that are not typically capitalized under generally accepted accounting principles.***

NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Cash equivalents policy

(Only if a statement of cash flows is presented.) For purposes of the statement of cash flows, the Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents.

The majority of the Company's cash is placed within one local banking institution. At times, the balance on deposit exceeds federally insured limits. To date, the Company has not experienced any losses in such account and believes it is not exposed to any significant credit risk on its cash and cash equivalents (ASC 825).

XYZ Company
Notes to Financial Statements- Tax Basis
For the Year Ended December 31, 20XX

Trade receivables

Trade receivables are recorded at net realizable value. Interest is not accrued on past due balances.

The Company uses the *direct writeoff method* to account for uncollectible accounts that are not recoverable. Using the direct writeoff method, trade receivable balances are written off to bad debt expense when an account balance is deemed to be uncollectible.

Accounts are considered past due once the unpaid balance is 90 days or more outstanding, unless payment terms are extended by contract. When an account balance is past due and attempts have been made to collect the receivable through legal or other means, the amount is considered uncollectible and is written off to expense.

The company's policy is not to charge interest on past due trade receivable balances.

At December 31, 20XX, trade receivables had a balance in the amount of $300,000.

Note

The above disclosure is the tax basis equivalent of the ASC 310 disclosure requirement in which an entity must disclose, among other items, the basis at which receivables are presented on the balance sheet.

Investments

Investments are stated at amortized cost and consist of amounts deposited in a mutual fund with a balance of $50,000 and a fair value of $70,000 (based on quoted prices) at year end.

Note

Because the statements are presented on the tax basis, fair market value accounting for investments per ASC 320 (formerly FASB No. 115) does not apply. However, the cost and fair value of the investments are generally disclosed.

Intangibles

Certain agreements not to compete in connection with asset acquisitions are amortized on a straight-line basis **over fifteen years**.

XYZ Company
Notes to Financial Statements- Tax Basis
For the Year Ended December 31, 20XX

Inventories

The Company values its inventories at cost using the first-in, first-out (FIFO) basis. Additionally, in accordance with Internal Revenue Code, certain general and administrative, and storage costs are capitalized, which approximates 5% of ending inventory.

Plant and equipment

Plant and equipment is stated at cost. Depreciation is computed using accelerated methods authorized under the Internal Revenue Code based on the following recovery periods:

	Recovery period (in years)
Motor vehicles	5
Machinery and equipment	7
Leasehold improvements	39
Building	39

In accordance with the Internal Revenue Code, the Company records additional depreciation in the year of acquisition of certain assets. The Company recorded *additional first-year depreciation in the amount of $24,000* in 20XX. After deducting first-year depreciation, the remaining cost is depreciated using the recovery periods noted above.

Advertising

Advertising is expensed as incurred and totaled $5,000.

Use of estimates

The preparation of financial statements in conformity with the tax basis of accounting requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Subsequent events

The Company has evaluated subsequent events through March 31, 20X1, which is the date through which the financial statements were available to be issued.

XYZ Company

Notes to Financial Statements- Tax Basis

For the Year Ended December 31, 20XX

Note

ASC 855, *Subsequent Events,* requires management to evaluate subsequent events through the date through which the financial statements were available to be issued, and to disclose that information. A similar disclosure is required for tax-basis financial statements.

Tax Uncertainties

The Company's policy is to record interest expense and penalties in operating expenses. For year ended December 31, 20XX, there was no interest and penalties expense recorded and no accrued interest and penalties.

The Company's federal and state tax returns are open for examination for three years from the date of filing.

Note

ASC 740, *Income Taxes,* requires an entity to disclose certain information about uncertain tax positions including the tax years that are open for examination for the IRS or state authority. The same disclosure would apply to tax-basis financial statements.

NOTE 4: INVENTORIES

Inventories consist of the following, by component:	
Raw materials and supplies	$50,000
Work in process	50,000
Finished goods	120,000
	220,000
Additional general and administrative and storage costs capitalized	**30,000**
	$250,000

XYZ Company
Notes to Financial Statements- Tax Basis
For the Year Ended December 31, 20XX

NOTE 5: RELATED PARTY TRANSACTIONS

From time to time, the company borrows from a shareholder to accommodate cash flow requirements. Interest is payable at 5% per annum and is recorded as an expense when paid in accordance with Internal Revenue Code requirements.

NOTE 6: PLANT AND EQUIPMENT

The components of fixed assets and related costs are as follows:

Cost:	
Machinery and equipment	$200,000
Computer and office fixtures	50,000
Leasehold improvements	900,000
	1,150,000
Less accumulated depreciation	500,000
Net book value	$650,000

Depreciation expense was $85,000, including $24,000 of additional first-year depreciation on certain equipment.

NOTE 7: LONG-TERM DEBT

Long-term debt consisted of the following at December 31, 20XX:

Bank Note: Mortgage loan payable in monthly principal payments of $6,667 (annual of $80,000) plus interest at 3%. The unpaid note balance is due on December 31, 20X6. The note is secured by a first mortgage on certain company real estate.	$500,000
Shareholder: Unsecured term note requiring semiannual principal payments of $10,000 through June 30, 20X20, plus interest at 110% of the treasury bill rate (3.3% rate at December 31, 20XX)	200,000
	700,000
Less current portion	100,000
	$600,000

XYZ Company
Notes to Financial Statements- Tax Basis
For the Year Ended December 31, 20XX

A summary of the annual maturities of long-term debt for the five years subsequent to year end follows:

Year	Principal payments
20X1	$100,000
20X2	100,000
20X3	100,000
20X4	100,000
20X5	100,000

Note

The five-year amortization is not required in this example. The reason is that the reader can obtain the principal payments for the five years based on the description of the loan terms above. SAS No. 122, AU-C Section 800, states that a GAAP format does not have to be followed for disclosures provided the reader can obtain the same result from the information given. Qualitative information prevails. Also, interest expense would normally be disclosed in this note. However, it is already disclosed on the face of the statement of income.

NOTE 8: INCOME TAXES

The provision for income taxes consists of federal and state income taxes currently payable. A summary of the provision follows:

Federal income taxes	$7,500
State income taxes	5,000
	$12,500

XYZ Company
Notes to Financial Statements- Tax Basis
For the Year Ended December 31, 20XX

Note

Using the format of this statement of income, this disclosure is not required because the components of federal and state taxes are already presented on the statement of income.

NOTE 9: LEASES

The Company has entered into various equipment leases with total monthly payments of $8,000 and various expiration dates through 20X6. A summary of the future minimum lease payments under these operating leases follows.

Year	Minimum lease payments
20X1	$96,000
20X2	96,000
20X3	96,000
20X4	96,000
20X5	96,000
Beyond 20X5	75,000
Total minimum lease payments	$555,000

Total rent expense under these leases was $94,000.

Note

Similar to the long-term debt note, the table above could be replaced with qualitative information that provides the reader with the same information. For example, insert the following additional language into the description and remove the table as follows:

The Company has entered into various equipment leases with total monthly payments of $8,000 and various expiration dates through 20X6. Total lease payments under these leases will approximate $96,000 per year during the next five years, with the balance beyond five years totaling approximately $75,000. Total rent expense under these leases was $94,000.

NOTE 10: PENSION PLANS

The Company is the sponsor of a profit-sharing plan. All employees, exclusive of those covered by collective bargaining agreements, are eligible to enter the Plan within one year of the commencement of employment. Contributions to the Plan were $23,000.

NOTE 11: CONTINGENCIES

The Company has been named in a lawsuit that involved use of the company's product by a customer. The possible loss from this lawsuit could range from $50,000 to $200,000. Management believes that this suit is frivolous and any liability, if any, will not have a material effect on the company.

NOTE 12: SUBSEQUENT EVENT

On February 5, 20X1, the Company entered into an agreement to purchase certain assets of ABC Corporation for $300,000. The assets to be purchased consist of certain plant and equipment, inventories and selected accounts receivable, along with a three-year agreement not to compete from an officer of ABC Corporation.

NOTE 13: CAPITAL STRUCTURE

As of December 31, 20XX, the company had 100 shares of no-par common stock issued and outstanding. Dividends are paid at the discretion of the board of directors.

NOTE 14: AGREEMENT NOT TO COMPETE

As part of a previous acquisition of certain assets of Z Company, the company entered into an agreement with the former owner of Z Company. The terms of the agreement provide that for a payment of $150,000, the owner will not compete in the medical market for a period of five years through September 30, 20X4. The agreement is amortized on a straight-line basis over a fifteen-year period in accordance with Internal Revenue Code requirements. As of December 31, 20XX, the unamortized balance of the agreement was $100,000.

NOTE 15: MAJOR CUSTOMERS

Approximately 30% of the company's sales were made to one customer.

- end of notes -

Example 3: Tax-Basis Review Report With a Tax-Basis Departure

Facts: Same as Example 2 except that an allowance for bad debts is set up for $10,000, which is a departure from the tax-basis accounting. Assume that the tax effect on the entry is not material.

Review Report- Tax Basis of Accounting with Report Exception (SSARS No. 21)

Independent Accountant's Review Report

Board of Directors
XYZ Company

We have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheet- tax basis as of December 31, 20XX, the related statements of income and retained earnings- tax basis, and the statement of cash flows- tax basis,[7] for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's financial data and making inquiries of management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statement as a whole. Accordingly, we do not express such an opinion.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the basis of accounting the company uses for income tax purposes; this includes determining that the basis of accounting the company uses for income tax purposes is an acceptable basis for the preparation of financial statements in the circumstances.[8] Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Accountant's Responsibility

Our responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants. Those standards require us to perform procedures to obtain limited assurance as a basis for reporting whether we are aware of any material modifications that should be made to the financial statements for them to be in accordance with the basis of accounting the company uses for income tax purposes. We believe that the results of our procedures provide a reasonable basis for our report.

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7. When issuing tax-basis financial statements, the statement of cash flows is optional.
8. When management has a choice of financial reporting frameworks, AR-C 90 requires that the review report make reference to management's responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances.

Independent Accountant's Review Report (continued)

Accountant's Conclusion

Based on our review, except for the issue noted in the Known Departure From the Basis of Accounting Used for Income Tax Purposes paragraph, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with the basis of accounting the company uses for income tax purposes.

Basis of Accounting[9]

We draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared in accordance with the basis of accounting the company uses for income tax purposes, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our conclusion is not modified with respect to this matter.

Known Departure From the Basis of Accounting Used for Income Tax Purposes

As described in Note XX, the tax basis of accounting requires that writeoffs on uncollectible trade receivables be recorded using the direct writeoff method. Management has informed us that the allowance method has been used to record an estimate of uncollectible accounts. If the direct writeoff method had been used, stockholders' equity and net income would have increased by $10,000.

James J. Fox & Company, CPA
Burlington, Massachusetts

March 20, 20X1

Note

Typically, the effect of the departure on a net of tax basis would be disclosed in the report. In this example, there is no tax effect so that the amount is disclosed gross in the amount of $10,000.

9. When a special purpose framework report is issued, the review report must include an emphasis-of-matter paragraph labeled "Basis of Accounting" or a similar title.

Example 3: Reviewed Financial Statements With a Tax-Basis Departure

XYZ Company Balance Sheet- Tax Basis December 31, 20XX	
ASSETS	
Current assets:	
Cash	$200,000
Accounts receivable-trade (**net of allowance; $10,000**)	290,000
Inventories	250,000
Prepaid expenses	150,000
Total current assets	890,000
Plant and equipment:	
Cost	1,150,000
Less accumulated depreciation	500,000
Total plant and equipment	650,000
Other assets:	
Agreement not to compete	100,000
Investments	50,000
Total other assets	150,000
	$1,690,000
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current liabilities:	
Accounts payable	$700,000
Accrued expenses	200,000
Current portion of long-term debt	100,000
Total current liabilities	1,000,000
Long-term debt	600,000
Stockholders' equity:	
Common stock	100
Retained earnings	89,900
Total stockholders' equity	90,000
	$1,690,000

See notes to financial statements.

Example 3: Reviewed Financial Statements With a Tax-Basis Departure

XYZ Company
Statement of Income and Retained Earnings- Tax Basis
For the Year Ended December 31, 20XX

Net sales	$1,192,000
Cost of sales- tax return	800,000
Gross profit	392,000
Deductible expenses:	
Officer's compensation	25,000
Salaries and wages	25,000
Utilities	10,000
Advertising and promotion	5,000
Insurance	2,000
Uncollectible accounts	21,000
Rent expense	94,000
Retirement plan expense	23,000
Payroll taxes and fringe benefits	12,000
State excise taxes	5,000
Amortization	10,000
Interest	18,000
Depreciation	85,000
Sundry other expenses	5,000
Total deductible expenses	340,000
Taxable state income	52,000
State income taxes	(5,000)
Taxable federal income	47,000**
Non-taxable and non-deductible item:	
Federal income tax expense	(7,500)
Non-deductible life insurance	(12,000)
Non-deductible meals and entertainment	(2,500)
Additional writeoffs of uncollectible accounts	**(10,000)**
Non-taxable interest income	3,000
Net income	18,000
Retained earnings:	
Beginning of year	71,900
End of year	$89,900

** Agrees with line 28 of tax return.

See notes to financial statements

Example 3: Reviewed Financial Statements With a Tax-Basis Departure

XYZ Company
Statement of Cash Flows- Tax Basis
For the Year Ended December 31, 20XX

Cash flow from operating activities:	
Net income	$18,000
Adjustments to reconcile net income to net cash provided by operating activities	
Depreciation and amortization	95,000
Change in trade receivables	**110,000**
Change in inventories	60,000
Change in accounts payable	(30,000)
Change in accrued expenses	(20,000)
Change in prepaid expenses	(10,000)
	223,000
Cash flows from investing activities:	
Purchases of equipment	(150,000)
	(150,000)
Cash flows from financial activities:	
Repayment of long-term debt	(100,000)
Decrease in cash and cash equivalents	(27,000)
Cash and cash equivalents:	
Beginning of year	227,000
End of year	$200,000
Supplementary cash flow disclosures:	
Interest paid	$18,000
Income taxes paid	12,500

See notes to financial statements.

Additional Note: Example 3

The following note would be added to the notes to financial statements, reflecting the tax-basis departure:

Note XX: Uncollectible Accounts

> The tax basis of accounting requires that writeoffs on uncollectible trade receivables be recorded using the direct writeoff method, which records the writeoff and related expense when the account is deemed uncollectible. Management has informed us that the allowance method has been used whereby an estimate of uncollectible accounts has been recorded prior to the accounts actually becoming uncollectible. If the direct writeoff method had been used, stockholders' equity and net income- tax basis, would have increased by $10,000.[10]

Report modification: compilation or audit engagements

Assuming Example 3 relates to a compilation or an audit, each report would be modified as follows:

10. There is no tax effect to be disclosed.

Example 3: Tax-Basis Compilation Report- Substantially All Disclosures Omitted and Departure for Allowance Account

Compilation Report- Tax Basis of Accounting with Report Exception (SSARS No. 21)

Accountant's Compilation Report

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheet- tax basis as of the year ended December 31, 20XX, and the related statement of income and retained earnings- tax basis, for the year then ended in accordance with the tax basis of accounting, and for determining that the tax basis of accounting is an acceptable financial reporting framework.[11] We have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. We did not audit or review the financial statements nor were we required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, we do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

The financial statements are prepared in accordance with the tax basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America.

The tax basis of accounting requires that writeoffs on uncollectible trade receivables be recorded using the direct writeoff method. Management has informed us that the allowance method has been used to record an estimate of uncollectible accounts. If the direct writeoff method had been used, stockholders' equity and net income would have increased by $10,000.

Management has elected to omit substantially all the disclosures ordinarily included[12] in financial statements prepared in accordance with the tax basis of accounting. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the company's assets, liabilities, equity, revenue, and expenses. Accordingly, the financial statements are not designed for those who are not informed about such matters.

James J. Fox & Company, CPA
Burlington, Massachusetts

March 20, 20X1

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11. AR-C 80 states that when special purpose framework financial statements are prepared and management has a choice of frameworks, the accountant's compilation report should reference management's responsibility for determining that the framework is acceptable.

12. The term "ordinarily included" is used when tax-basis financial statements are issued in lieu of the term "required" for GAAP statements.

Audit Report- Tax Basis of Accounting with Report Exception (AU-C 800)

Independent Auditor's Report

Board of Directors
XYZ Company
Boston, Massachusetts

We have audited the accompanying financial statements of XYZ Company, which comprise the balance sheet- tax basis as of December 31, 20XX, and the related statements of income and retained earnings- tax basis for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the tax basis of accounting; this includes determining that the tax basis of accounting is an acceptable basis for the preparation of financial statements in the circumstances. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the partnership's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the partnership's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our *qualified audit opinion*.

Independent Auditor's Report (continued)

Basis for Qualified Opinion

***As described in Note X, the Company has recorded* uncollectible trade receivables using the allowance method which estimates uncollectible accounts. The tax basis of accounting requires that uncollectible accounts be recorded using the direct write off method. If the direct write off method had been used, stockholders' equity and net income- tax basis would have increased by $10,000.**

Opinion

In our opinion, *except for the effects of not using the direct writeoff method* as discussed in the Basis for Qualified Opinion paragraph, the financial statements referred to above present fairly, in all material respects, the balance sheet- tax basis of XYZ Company as of December 31, 20XX, and its income and retained earnings- tax basis for the year then ended, in accordance with the **basis of accounting the Company uses for income tax purposes as described in Note X**.

Basis of Accounting

We draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared on the basis of accounting the Company uses for income tax purposes, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

[Auditor's Signature]
[Auditor's City and State]

[Date of the Auditor's Report]

Example 4: Tax-Basis Audit Report

Accountants should consider using tax-basis financial statements more frequently for audit engagements. The key issue is whether third parties (e.g., banks, etc.) will accept them in lieu of GAAP statements. If a third party will accept tax-basis financial statements, there is no reason why tax-basis financial statements shouldn't be just as favorable for an audit client as reviewed or compiled statements.

If an audit is conducted, the report looks like the example report noted below. Disclosures are the same as the review engagement shown in previously presented Example 2.

Independent Auditor's Report

Board of Directors
XYZ Company
Boston, Massachusetts

We have audited the accompanying financial statements of XYZ Company, which comprise the balance sheet- tax basis as of December 31, 20XX, and the related statements of income and retained earnings- tax basis, and statement of cash flows- tax basis for the year then ended and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the tax basis of accounting; this includes determining that the tax basis of accounting is an acceptable basis for the preparation of financial statements in the circumstances. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the partnership's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the partnership's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Independent Auditor's Report (continued)

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities, and stockholders' equity of XYZ Company as of December 31, 20XX, and its revenue, expenses and retained earnings, and cash flows for the year then ended, in accordance with the basis of accounting the Company uses for income tax purposes as described in Note X.

Basis of Accounting

We draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared on the basis of accounting the Company uses for income tax purposes, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

[Auditor's Signature]
[Auditor's City and State]

[Date of the Auditor's Report]

H. CONVERTING TO TAX-BASIS FINANCIAL STATEMENTS

When a company converts from GAAP statements to tax-basis financial statements, there are generally **two options** available in the year of conversion.

1. Comparative statements presented:

   Restate the prior year's statements to tax basis and show **both years** on a comparative basis. The beginning retained earnings for the prior year **must be restated** to reflect the effect of the change to tax basis on prior years' income.

2. Current year statements presented only:

   Restate retained earnings for the year of change and **do not** present comparative statements for the prior years. Two options to reflect the restatement:

   - As an adjustment to beginning retained earnings, or
   - As a cumulative-effect of a change on the income statement

Observation

A change to tax-basis financial statements does not represent a change in accounting principle in accordance with ASC 250, *Accounting Changes and Error Corrections* (formerly FASB No. 154). Existing literature provides no guidance on how to present the change to tax-basis statements. In the author's opinion, it is more appropriate to present the change as an adjustment to the beginning retained earnings balance. Regardless of whether the change is presented as a cumulative effect or an adjustment to beginning retained earnings, the adjustment should be shown net of income taxes in accordance with intraperiod tax allocation.

The following provides an example of the options available in converting to tax-basis financial statements.

Example: Effective January 1, 20X1, a company converts from GAAP to tax-basis financial statements. As of that date, the differences between GAAP and tax-basis balance sheet are as follows:

January 1, 20X1	GAAP	Tax Return
Accrued vacation pay	100,000	0
Allowance for bad debts	50,000	0
UNICAP add-on to inventory	0	10,000
Deferred F&S taxes	56,000	0

The entry to restate for the implementation of tax-basis statements is as follows:

January 1, 20X1:		
Accrued vacation pay	100,000	
Allowance of bad debts	50,000	
Inventory	10,000	
Adjustment- tax basis		**160,000**
Adjustment- tax basis	**56,000**	
Deferred F&S taxes		56,000

The net adjustment is $104,000 ($160,000 less $56,000) and may be presented as follows:

Option 1: Restate beginning retained earnings:

Statement of Retained Earnings- Tax Basis

For the year ended December 31, 20X1

Retained earnings, January 1, 20X1:	
As originally stated	$xx
Restatement to reflect change to tax basis of accounting (net of income taxes; $56,000)	**104,000**
As restated	xx
20X1 net income, tax basis	xx
Retained earnings, December 31, 20X1	$xx

Option 2: Show restatement as a cumulative effect of change on income statement:

Statement of Income- Tax Basis

For the year ended December 31, 20X1

Net sales	$xx
Cost of sales	xx
Gross profit on sales	xx
Selling and general administrative expenses	xx
Net income before income taxes	xx
Income taxes (Note 4)	xx
Net income before cumulative effect of change to tax basis of accounting	xx
Cumulative effect of change to tax basis of accounting (net of income taxes; $56,000)	**104,000**
Net income	$xx

SAMPLE NOTE

NOTE 5: CHANGE TO TAX-BASIS FINANCIAL STATEMENTS:

In 20X0, the Company prepared its financial statements using accounting principles generally accepted in the United States of America. Effective January 1, 20X1, the Company adopted the basis of accounting used for federal income tax purposes for its financial statements. The accompanying 20X1 financial statements have been restated to conform with the new basis of accounting. As a result, retained earnings at January 1, 20X1 have been restated in the amount of $104,000 to reflect the change to the new method.

Report in Year of Change to Tax-Basis Statements from GAAP

Although not required, a practitioner may wish to add an explanatory paragraph to his or her report (audit, review or compilation report), identifying the fact that the company changed from GAAP to tax-basis financial statements.

Sample paragraph: (added at the end of the report)[13]

> As discussed in Note 1, in 20X1, the Company adopted a policy of preparing the financial statements on the accrual basis of accounting used for federal income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles. Accordingly, the accompanying financial statements are not intended to present financial position and results of operations in conformity with accounting principles generally accepted in the United States of America. **Retained earnings as of January 1, 20X1 have been restated to reflect the effect of the change on prior years' statements.**

Note

If the prior year statements are restated to tax basis, the last sentence above should be replaced with:

The financial statements for 20X0 have been restated to reflect the income tax basis of accounting adopted in 20X1.

I. CASH FLOWS STATEMENT

A statement of cash flows **is not required** for non-GAAP financial statements. ASC 230, *Statement of Cash Flows* (formerly FASB No. 95), requires entities to provide a statement of cash flows when GAAP financial statements are issued and there is a balance sheet and income statement presented. Consequently, when non-GAAP statements are presented, a cash flows statement is not required, but is optional.

As a practical point, many practitioners do, in fact, include a statement of cash flows in tax-basis financial statements that are either reviewed or audited. The reason is because the user, typically a bank, wants the statement of cash flows included.

J. TAX-BASIS FINANCIAL STATEMENT TITLES

Question: Is it appropriate to use the title "*Statement of Income- Tax Basis*," or "*Balance Sheet- Tax Basis*," in preparing tax-basis financial statements?

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13. A heading "Emphasis-of-Matter" (or similar heading) should be added to the paragraph for a review or audit report, but not a compilation report.

Response: AU-C 800 and SSARS No. 21 clarifies that traditional GAAP titles, such as *balance sheet, statement of income*, may be used for special purpose framework financial statements, provided such titles are *"appropriately modified."* That means that the title must be altered so that the reader clearly understands that the tax basis (or other special purpose framework) is being used, and not GAAP.

Examples of financial statement titles that are suitable for special purpose framework financial statements include, but are not limited to the following:

Modified cash basis:

- Income Statement- Modified Cash Basis
- Statement of Income- Modified Cash Basis**
- Statement of Cash Receipts and Disbursements

Tax basis:

- Balance Sheet- Tax Basis
- Statement of Assets, Liabilities, and Equity- Tax Basis
- Statement of Operations- Tax Basis
- Statement of Revenue and Expenses- Tax Basis
- Statement of Income- Tax Basis**

Regulatory basis:

- Statement of Income- Regulatory Basis
- Balance Sheet- Regulatory Basis

** Added to list by the author.

Observation

For years there has been confusion as to the titles that could be used for non-GAAP financial statements such as income tax-basis financial statements. The general rules were originally found in SAS No. 62, *Special Reports*, which stated that other comprehensive basis of accounting (OCBOA) financial statements should be "suitably titled" so as not to imply they are GAAP financial statements. SAS No. 62 provided limited guidance as to what was "suitably titled" and what was not.

Although not codified within SAS No. 62, some commentators, including the author, have believed that suitably titled financial statements could use the terms "balance sheet" and "statement of income" provided there was an appropriate suffix such as "income tax basis" or "cash basis" etc. Thus, the titles "balance sheet- income tax basis" and "statement of income- income tax basis" were appropriate titles if reporting on income tax-basis financial statements under the pre-SSARS No. 21 rules. Yet, some peer reviewers and other parties took a far more narrow position that the terms "balance sheet" and "statement of income" could not be used in a non-GAAP title regardless of whether an "income tax basis" suffix was attached. Thus, many practitioners have used titles such as "statement of assets, liabilities and equity- income tax basis" and "statement of revenues and expenses- income tax basis" even though titles such as "balance sheet- income tax basis" and "statement of income- income tax basis" could have been used.

SSARS No. 21 finally brings clarity to the situation by stating that with respect to special purpose frameworks, (such as tax basis), GAAP titles may be used provided such titles are "appropriately modified." SSARS No. 21 does offer some examples of titles that are considered "appropriately modified."

Following are examples of "appropriate" special purpose framework titles:

- Balance Sheet- Tax Basis**
- Statement of Income- Tax Basis**
- Statement of Income- Regulatory Basis
- Balance Sheet- Regulatory Basis

** Title included by author, but not included in list found in SSARS No. 21.

K. DISCLOSURE AND FINANCIAL STATEMENT REQUIREMENTS- TAX BASIS

As previously noted, AU-C 800 and SSARS No. 21 require that certain disclosures be included in tax-basis financial statements as follows:

1. A description of the special purpose framework (tax basis).

2. A summary of significant accounting policies.

3. An adequate description about how the special purpose framework (tax basis) differs from GAAP. The effects of these differences need not be quantified.

4. Informative disclosures similar to those required by GAAP when the financial statements contain items that are the *same as, or similar to*, those in financial statements prepared in accordance with GAAP.

Note

In the case of financial statements prepared in accordance with a contractual basis of accounting, the disclosures should adequately describe any significant interpretations of the contract on which the financial statements are based.

When the special purpose financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, informative disclosures similar to those required by GAAP are necessary to achieve fair presentation.

1. If special purpose financial statements contain items for which GAAP would require disclosure, the financial statements may either:

    - Provide the relevant disclosure that would be required for those items in a GAAP presentation, or
    - Provide *qualitative information* that communicates the substance of that disclosure.

Note

Qualitative information may be substituted for quantitative information required by GAAP. For example, GAAP requires disclosure of the future principal payments on long-term debt over the next five years. For tax-basis financial statements, this disclosure could be satisfied by merely disclosing the repayment terms of significant long-term borrowings without quantifying it in a schedule.

Note

Tax-basis financial statements should include the same GAAP disclosures provided they are relevant and applicable to the tax basis. For example, a disclosure of unrealized gains on securities and actuarial disclosures for defined benefit pensions would not be relevant to tax-basis statements.

L. AUTHORITY FOR TAX-BASIS DISCLOSURES

SAS No. 122, AU-C Section 800: Special Considerations- *Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*, and SSARS No. 21, *Statements on Standards for Accounting and Review Services: Clarification and Recodification*, provide guidance as to the extent of disclosures that are required when reporting on special purpose frameworks, which include tax-basis financial statements.

AU-C 800 and SSARS No. 21 require that financial statements prepared on a special purpose framework (such as tax basis) should include the following disclosures:

- A description of the special purpose framework (tax basis).
- A summary of significant accounting policies.
- An adequate description about how the special purpose framework (tax basis) differs from GAAP. The effects of these differences need not be quantified.
- Informative disclosures similar to those required by GAAP when the financial statements contain items that are the *same as, or similar to,* those in financial statements prepared in accordance with GAAP.

When special purpose financial statements contain items that are the same as, or similar to, GAAP statements, the disclosures for depreciation, long-term debt, and owners' equity should be comparable to those found in GAAP financial statements. In addition, there may be a need for disclosure of matters that are not specifically identified on the face of the statements such as:

- Related party transactions
- Restrictions on assets and owners' equity
- Subsequent events
- Uncertainties

How should the guidance of AU-C 800 and SSARS No. 21 be applied in evaluating the adequacy of disclosure in financial statements prepared on the cash, modified cash, or income tax basis of accounting?

Response: First, the basis of accounting note may be brief with only the primary differences from GAAP being described. For example, assume that there are several differences between tax basis and GAAP as follows:

Allowance for bad debts	Insignificant
Depreciation difference	Significant
UNICAP- Section 263A adjustment	Insignificant

In the basis of accounting note, only a brief description of the depreciation difference would be required with no mention of the other differences. Quantifying the differences is not required.

Example

Basis of Accounting: The accompanying financial statements present financial results on the accrual basis of accounting used for federal income tax purposes which ***differs*** from the accrual basis of accounting required under generally accepted accounting principles. The ***primary difference*** between the Company's method and the method required by generally accepted accounting principles is that ***depreciation has been recorded using accelerated methods authorized by the Internal Revenue Code***.

What disclosures are required in tax-basis financial statements?

Tax-basis disclosures should be the "same as, or similar to" GAAP disclosures.

Following is guidance to be followed in determining which disclosures should be included in tax-basis financial statements:

1. If tax-basis financial statements contain elements, accounts, or items for which GAAP would require disclosure, the statements should either provide a relevant disclosure or provide information that effectively communicates the substance of that disclosure.
    - Qualitative information may be substituted for quantitative information required by GAAP.
    - Modification of the financial statement format is <u>not required</u>.

Example: GAAP requires disclosure of the future principal payments of long-term debt over the next five years.

For tax-basis financial statements, this disclosure should be satisfied by merely disclosing the repayment terms of significant long-term borrowings without quantifying it in a schedule.

2. GAAP disclosures that are not relevant to tax-basis financial statements are not required.

    Examples include:

a) Fair value information required for investments accounted for at fair value in accordance with ASC 320, *Investments* (formerly found in FASB No. 115). Fair value information would not be relevant for tax basis because they would be recorded at cost.

b) For defined benefit plans, information based on actuarial calculations that ASC 715 (formerly FASB No. 158) required for GAAP financial statements would not be relevant to tax-basis financial statements.

3. The tax-basis financial statement format should comply with GAAP requirements or provide information that communicates the substance of those requirements. Such information may be communicated using qualitative information without modifying the financial statement format.

Examples

Financial Statement Item(s)	GAAP	Tax Basis
Information about the effects of accounting changes, discontinued operations, and extraordinary items.	Must be shown on the statement of income, net of the tax effect.	May be shown on the statement of income, or, alternatively, may be disclosed in the notes, net of the tax effect.
A not-for-profit organization shows expenses by their functional classification.	Shown in the statement of activity, by functional classifications.	May be shown in the statement of activity, or, alternatively, may present expenses by their natural classification and, in a note, could use estimated percentages to communicate information about expenses incurred by major program and supporting services.
A not-for-profit organization shows the amounts of, and changes in, unrestricted, temporarily restricted, and permanently restricted net assets.	Such classifications are presented in the statement of activity and statement of net assets.	Totals may be shown on the statements of activity and net assets with a breakout presented in the notes using estimates or percentages.

4. <u>Statement of Cash Flows Issues</u>

A statement of cash flows is not required for non-GAAP financial statements, such as those prepared on the tax basis. However, if cash receipts and disbursements basis of accounting is used, the income statement is effectively a cash flow statement. If a statement of cash flows is presented in tax-basis financial statements (or any other special purpose framework), the cash flow statement should either conform to the requirements for a GAAP statement of cash flows, or disclose the substance of those requirements.

Example: A Company issues tax-basis accrual financial statements and decides to include a statement of cash flows although not required.

Conclusion: The statement of cash flows should either conform with the GAAP requirements for a cash flow statement, or the same types of cash flow disclosures should be made either on the statement or in the notes. For example, noncash transactions, such as purchasing a fixed asset with borrowings, should be disclosed in the notes.

5. <u>Other disclosures</u>

If GAAP requires disclosure of other matters such as contingent liabilities, going concern, and significant risks and uncertainties, an entity should consider the need for that same disclosure. However, disclosures that are irrelevant to tax-basis financial statements need not be included.

Example: A disclosure about the use of estimates that is required by ASC 275 (formerly SOP 94-6) would not be relevant in a cash receipts and cash disbursements basis of accounting which has no estimates.

Observation

Qualitative information may be substituted for quantitative information, and the statements need not be modified. For example, the presentation of the five-year amortization of long-term debt could be eliminated if there is a description of the debt terms. This would also be the case with respect to operating leases.

M. DISCLOSURES OF FAIR VALUE- TAX BASIS

Question: If an entity presents financial statements on the tax basis of accounting, must fair value disclosures be included in the notes?

Response: Generally not.

GAAP requires an entity to record fair value disclosures as follows:

a. Items recorded on the balance sheet at fair value: all entities must include fair value disclosures.

b. Financial instruments not recorded at fair value: SEC companies, and nonpublic entities with either 1) total assets of $100 million or more or 2) recorded derivatives.

With respect to tax-basis financial statements, assets and liabilities that would otherwise be recorded at fair value (such as investments in equity securities, derivatives, etc.), are recorded at cost. Therefore, an entity would not be required to include disclosures about fair value information with respect to those items.

However, if a nonpublic entity has total assets of $100 million or more or recorded derivatives, GAAP requires that entity to include fair value disclosures for all financial instruments even if those instruments are not recorded at fair value. A similar disclosure would be required if that same large nonpublic entity ($100 million or more, or derivatives) issued tax-basis financial statements.

Example: Company X is a nonpublic entity with total assets of $20 million for which tax-basis financial statements are issued. X has an investment in equity securities recorded at cost under the tax basis of accounting.

Conclusion: Fair value disclosures are not required for GAAP because X has no assets and liabilities recorded at fair value. Thus, no fair value disclosures are required for tax-basis financial statements for the investment in equity securities.

Example 2: Company X is a nonpublic entity with total assets of $150 million for which tax-basis financial statements are issued. X has an investment in equity securities recorded at cost under the tax basis of accounting.

Conclusion: Because X has total assets of $100 million or more, GAAP requires X to include fair value information about financial instruments *even if those instruments are not recorded at fair value*. That's the GAAP side of the rules.

When tax-basis financial statements are issued, such statements must include disclosures that are "*same as or similar to*" those disclosures required by GAAP. Thus, X would have to include fair value disclosures about its financial instruments even though they are not recorded at fair value in the tax-basis financial statements. In this example, fair value disclosures would be required for the investment in equity securities even though that investment is recorded at cost.

Should the fact that fair value is not used be disclosed as a primary difference between tax-basis and GAAP financial statements?

Yes. When tax-basis financial statements are issued, SAS No. 122, AU-C Section 800: *Special Considerations- Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*, provides guidance as to the extent of disclosures that are required when reporting on special purpose frameworks, which includes tax-basis financial statements.

The AU-C requires that financial statements prepared on a special-purpose framework (such as tax basis) should include the following disclosures:

- A description of the special purpose framework (tax basis).
- A summary of significant accounting policies.
- An adequate description about how the special purpose framework (tax basis) differs from GAAP. The effects of these differences need not be quantified.
- Informative disclosures similar to those required by GAAP when the financial statements contain items that are the *same as, or similar to*, those in financial statements prepared in accordance with GAAP.

One of the differences that should be disclosed is the fact that certain assets that would be recorded at fair value under GAAP are recorded at cost under the tax basis.

NOTE X: BASIS OF ACCOUNTING

The accompanying financial statements present financial results on the accrual basis of accounting used for federal income tax purposes which ***differs*** from the accrual basis of accounting required under generally accepted accounting principles. The ***primary differences*** between the Company's method and the method required by generally accepted accounting principles are that a) depreciation has been recorded using accelerated methods authorized in the Internal Revenue Code, b) uncollectible accounts on accounts receivable are recorded when deemed uncollectible without use of an allowance account, c) certain accruals for compensation and other expenses are recorded when paid rather than when incurred, d) certain costs are capitalized to inventory that are not typically capitalized under generally accepted accounting principles, and ***e) certain investments are recorded at cost when such investments are recorded at fair value under generally accepted accounting principles.***

The above element would only apply if the entity has investments that, under GAAP, would be recorded at fair value.

N. MISCELLANEOUS DISCLOSURES – TAX BASIS

Question: Is an entity required to disclose information on management's evaluation of subsequent events in tax-basis financial statements?

Response: Yes. Such a disclosure is required for all financial statement frameworks.

Question: Do the consolidation of variable interest entity rules and requirements found in FIN 46R apply to financial statements prepared using the tax basis of accounting?

Response: No. Because the Internal Revenue Code does not provide for consolidation of variable interest entities, the FIN 46R rules and their application do not apply to tax-basis financial statements.

O. OTHER TAX-BASIS ISSUES

Compliance with Bank Loan Covenant Requirement:

Prior to converting to tax-basis financial statements, a company should make sure that the issuance of tax-basis financial statements would not be in violation of the bank loan covenants. Many loan documents specifically state that a company must submit audited (reviewed or compiled) financial statements prepared in accordance with GAAP. Issuing tax-basis financial statements may be in direct violation of that provision, and may require a waiver letter from the bank.

P. USING TAX BASIS BASED ON A METHOD THAT DIFFERS FROM THE INCOME TAX RETURN

Question: May an entity that uses the cash basis of accounting to prepare its federal income tax return use the tax basis of accounting for its financial statements using the accrual basis?

Response: AU-C 800 and SSARS No. 21 define tax basis as:

> *"A basis of accounting that the entity <u>uses to file its income tax return</u> for the period covered by the financial statements."*

What this means is that the entity must use the basis it uses to prepare its tax return. Thus, if the tax return is prepared on the cash basis, the tax-basis financial statements must also be prepared on a cash basis. Further, if the entity wishes to prepare tax-basis financial statements on an accrual basis, it must file its income tax return on an accrual basis.

This situation is problematic for many companies who file their income tax return on a cash basis, yet wish to prepare tax-basis financial statements on an accrual basis, as it is more meaningful to do so. Such a scenario is not authorized by AU-C 800 and SSARS No. 21.

There are two solutions:

1. Solution 1: Use a tax basis of accounting departure.
2. Solution 2: Issue the tax-basis financial statements within the "other basis" category of a special purpose framework.

SOLUTION 1: Use a tax basis of accounting departure

One way to issue tax-basis financial statements on an *accrual basis*, while continuing to file cash basis income tax returns, is to issue a report with a tax basis of accounting departure, similar to a GAAP departure. The difference is that there is a departure from the rules for the tax basis of accounting (found in AU-C 800 and SSARS No. 21). AU-C 800 and SSARS No. 21 require the basis to be the same as the one used for filing the income tax return. By preparing tax-basis financial statements on an accrual basis while the actual tax return is filed on a cash basis, the entity violates AU-C 800 and SSARS No. 21.

Following are sample reports:

Compilation Report- Tax Basis of Accounting with Report Exception for Tax-Basis Departure

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheet- tax basis as of the year ended December 31, 20XX, and the related statement of income and retained earnings- tax basis, for the year then ended in accordance with the tax basis of accounting, and for determining that the tax basis of accounting is an acceptable financial reporting framework.[14] We have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. We did not audit or review the financial statements nor were we required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, we do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

The financial statements are prepared in accordance with the tax basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America.

The tax basis of accounting requires that financial statements prepared on the tax basis of accounting use the same basis used to file the Company's income tax return. Management has informed us that the company has prepared the accompanying financial statements on the accrual basis of accounting while it files its federal income tax return on the cash basis of accounting. If the cash basis had been followed, net income and stockholders' equity would have decreased by $100,000.

Management has elected to omit substantially all the disclosures ordinarily included[15] in financial statements prepared in accordance with the tax basis of accounting. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the company's assets, liabilities, equity, revenue, and expenses. Accordingly, the financial statements are not designed for those who are not informed about such matters.

James J. Fox & Company CPA
Burlington, Massachusetts

March 20, 20X1

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14. AR-C 80 states that when special purpose framework financial statements are prepared and management has a choice of frameworks, the accountant's compilation report should reference management's responsibility for determining that the framework is acceptable.

15. The term "ordinarily included" is used when tax-basis financial statements are issued in lieu of the term "required" for GAAP statements.

Review Report- Tax Basis of Accounting with Report Exception for Tax-Basis Departure

<u>Independent Accountant's Review Report</u>

Board of Directors
XYZ Company

We have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheet- tax basis as of December 31, 20XX, the related statements of income and retained earnings- tax basis, and the statement of cash flows- tax basis,[16] for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's financial data and making inquiries of management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statement as a whole. Accordingly, we do not express such an opinion.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the basis of accounting the company uses for income tax purposes; this includes determining that the basis of accounting the company uses for income tax purposes is an acceptable basis for the preparation of financial statements in the circumstances.[17] Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Accountant's Responsibility

Our responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants. Those standards require us to perform procedures to obtain limited assurance as a basis for reporting whether we are aware of any material modifications that should be made to the financial statements for them to be in accordance with the basis of accounting the company uses for income tax purposes. We believe that the results of our procedures provide a reasonable basis for our report.

16. When issuing tax-basis financial statements, the statement of cash flows is optional.
17. When management has a choice of financial reporting frameworks, AR-C 90 requires that the review report make reference to management's responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances.

Independent Accountant's Review Report (continued)

Accountant's Conclusion

Based on our review, except for the issue noted in the Known Departure From the Basis of Accounting Used for Income Tax Purposes paragraph, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with the basis of accounting the company uses for income tax purposes.

Basis of Accounting[18]

We draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared in accordance with the basis of accounting the company uses for income tax purposes, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our conclusion is not modified with respect to this matter.

Known Departure From the Basis of Accounting Used for Income Tax Purposes

As described in Note 2, the tax basis of accounting requires that financial statements prepared on tax basis of accounting use the same basis used to file the company's income tax return. Management has informed us that the company has prepared the accompanying financial statements on the accrual basis of accounting while it files its federal income tax return on the cash basis of accounting. If the cash basis had been followed, net income and stockholders' equity would have decreased by $100,000.

James J. Fox & Company, CPA
Burlington, Massachusetts

March 20, 20X1

SOLUTION 2: Issue Tax-Basis Financial Statements Under the "Other Basis" Category

There is a second solution when issuing tax-basis financial statements on a basis that is not identical to the one used to file the tax return. That solution is to issue the financial statements under the "other basis" category of the special purpose framework, instead of the tax basis category.

The definition of a special purpose framework found in AU-C 800 and SSARS No. 21 includes any one of the following bases of accounting:

> Cash basis: A basis of accounting that the entity uses to record cash receipts and disbursements and modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets).

18. When a special purpose framework report is issued, the review report must include an emphasis-of-matter paragraph labeled "Basis of Accounting" or a similar title.

Tax basis: A basis of accounting that the entity uses to file its income tax return for the period covered by the financial statements.

Regulatory basis: A basis of accounting that the entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject.

Contractual basis: A basis of accounting that the entity uses to comply with an agreement between the entity and one or more third parties other than the auditor.

Other basis: A basis of accounting that uses a definite set of logical, reasonable criteria that is applied to all material items appearing in financial statements.

As previously discussed in this section, the tax basis is defined as the basis "the entity uses to file its income tax return." Again, if an entity issues tax-basis financial statements on an accrual basis while the tax return is filed on a cash basis, those tax-basis financial statements violate the definition of "tax basis." The author suggests another solution which is to issue the financial statements as an "other basis" of accounting.

The definition of an "other basis" is:

"A basis of accounting that uses a definite set of logical, reasonable criteria that is applied to all material items appearing in financial statements."

This definition is open-ended and essentially permits the issuance of financial statements using any non-GAAP format provided the basis represents a "definite set of logical, reasonable criteria." Clearly, issuing financial statements that follow the Internal Revenue Code should represent a "definite set of logical, reasonable criteria" although some commentators might argue that the Code is nothing but illogical.

If tax-basis financial statements are issued under the "other basis" category, because the accrual basis is used while the tax return is filed on a cash basis, the reports would have the following basis of accounting paragraphs:

Compilation report:

The financial statements are prepared in accordance with an *other basis of accounting using logical, reasonable criteria established under the Internal Revenue Code*, which is a basis of accounting other than accounting principles generally accepted in the United States of America.

Review report:

Basis of Accounting

We draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared on an *other basis of accounting using logical, reasonable criteria established under the Internal Revenue Code*, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our conclusion is not modified with respect to this matter.

Audit report:

Basis of Accounting

We draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared on an *other basis of accounting using logical, reasonable criteria established under the Internal Revenue Code*, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Q. COMBINING FINANCIAL STATEMENTS PREPARED IN ACCORDANCE WITH THE TAX BASIS OF ACCOUNTING

Question: There is a group of brother-sister corporations in which each entity maintains its books and records on the basis of accounting used to file each entity's income tax return. May the entities' financial statements be combined on a tax basis even though a combined income tax return is not filed?

Response: TIS Section 1400, Consolidated Financial Statements – Combining Financial Statements Prepared in Accordance With the Tax Basis of Accounting, provides some guidance even though it applies to audit engagements and not directly to GAAP.

The TIS, as modified, states:[19]

AU-C Section 800, *Special Considerations – Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*, provides a definition of the tax basis of accounting as "a basis of accounting that the entity uses to file its income tax return for the period covered by the financial statements."

Nothing in the AU-C prohibits or precludes an auditor from reporting on a combined presentation as long as the basis of accounting for each of the entities presented is the basis that is used to file the income tax returns. In many instances, combining financial statements of brother-sister companies is more useful to users than the individual uncombined financial statements. As with all tax-basis presentations, the auditor should consider whether the financial statements (including the accompanying notes) include all informative disclosures that are appropriate for the basis of accounting used.

Although the TIS does not directly relate to GAAP, the author believes that an accountant should follow the same conclusion made for this practice aid for all engagements. Specifically, if an accountant performs a compilation or review engagement involving combined financial statements of related entities that do not file a combined tax return, the accountant is permitted to issue that report under the tax basis of accounting. Even though a combined tax return is not filed with the IRS, the accountant is permitted to report on a tax-basis combined financial statement as long as the financial statements of the individual entities are on the same basis used to file each entity's federal income tax return.

19. The TIS was originally issued with reference to SAS No. 62, Special Reports, which has been superseded by AU-C Section 800 effective at the end of 2012.

R. DISREGARDED ENTITIES AND TAX-BASIS FINANCIAL STATEMENTS

Questions: If the entity is disregarded for federal income tax purposes, is an accountant permitted to report on that entity as it is not recognized for tax purposes?

Response: Yes.

There are instances in which an accountant is permitted to report on tax-basis financial statements related to a disregarded entity, such as a:

- Grantor trust
- One-member LLC.

Example: Company X, a one-member LLC, does not file a tax return as it is a disregarded entity for income tax purposes. The sole member of X is John and Company X's income is reported on John's personal tax return.

The accountant is Joe CPA and he wants to issue a review report on Company X.

Joe is concerned that he may not be permitted to report on tax-basis financial statements for Company X because X does not file income tax returns.

Is Joe permitted to report on tax-basis financial statements for Company X?

Response: Yes. Under newly issued AU-C 800 and SSARS No. 21, a tax-basis framework is considered a special purpose framework. Both AU-C 800 and SSARS No. 21 define a special purpose framework to include the following non-GAAP bases of accounting:

- **Cash basis:** A basis of accounting that the entity uses to record cash receipts and disbursements and modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets).
- **Tax basis:** A basis of accounting that the entity uses to file its income tax return for the period covered by the financial statements.
- **Regulatory basis:** A basis of accounting that the entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject.
- **Contractual basis:** A basis of accounting that the entity uses to comply with an agreement between the entity and one or more third parties other than the auditor.
- **Other basis:** A basis of accounting that uses a definite set of logical, reasonable criteria that is applied to all material items appearing in financial statements.

The tax basis is defined as a:

> "basis of accounting that the entity *uses to file its income tax return* for the period covered by the financial statements."

However, in this example, X does not file income tax returns.

AU-C 800 and SSARS No. 21 do not address the issue of what happens if the reporting entity does not directly file income tax returns. However, there is a similar example found in an AICPA Technical Practice Aid, *TIS Section 1400, Consolidated Financial Statements: Combining Financial Statements Prepared in Accordance With the Tax Basis of Accounting*.

The TIS addresses the issue of whether an auditor is permitted to report on tax-basis financial statements that differ from the way in which tax returns are filed.

The example found in the TIS deals with brother-sister entities, each of which files its own tax return. Yet, for financial statement purposes, the entities are combined and tax-basis financial statements are issued on a combined basis, which is not the same way in which the tax returns are filed.

The nonauthoritative conclusion reached in the TIS is that nothing prohibits or precludes an auditor (or accountant) from reporting on the combined tax-basis presentation as long as the basis of accounting for each of the underlying entities is the one each *uses* to file its income tax return for the reporting period.

Although the facts are not quite the same in the previous LLC example, it would appear that a similar conclusion can be reached; that is, as long as the LLC's financial statements are issued in the format used to file the LLC's net income (taxable income) on John's personal return (typically on Schedule E and C), tax-basis financial statements may be issued for the LLC and Joe CPA may report on them.

Question: Because the entity is disregarded, should the financial statements be titled as those related to a sole proprietorship (Schedule C or E) or as an entity (LLC or trust)?

There is no authority for this matter. Some commentators believe that because the LLC or grantor is a disregarded entity, the entity form should be ignored in preparing the financial statements and should be titled as a sole proprietorship (Schedule C or E).

Others believe that the substance of the transaction is that it is a separate LLC or trust and therefore, the identity of the entity should be retained even though the entity is disregarded for tax purposes.

There is no authoritative answer. The author suggests that the best approach is to recognize the entity in the form of the financial statements even though the entity is disregarded for tax purposes. That means the accountant should report on the entity as a trust or LLC, and not as a sole proprietorship.

Example:

John James is the grantor and sole beneficiary of the JSM Realty Trust, a grantor trust for income tax purposes. The trust holds title to one piece of residential rental property.

Mary Smith, CPA, is asked to issue a compilation report on the trust using the tax basis of accounting.

Mary does not issue a tax return for the grantor trust. Instead, the net rental income of the trust is recorded on Schedule E of John's Form 1040.

Conclusion: Mary is probably permitted to issue financial statements on the tax basis of accounting for the trust even though the trust does not file an income tax return.

Question: Does the decision to report on a grantor trust as a trust (instead of a sole proprietorship) change if the accountant files a Form 1041 Grantor Trust information return for the grantor trust?

Response: Although a grantor trust is a disregarded entity, the entity is permitted to file a Form 1041 grantor trust return with grantor information. If a Form 1041 trust return is filed for the grantor trust, the accountant should report on the trust as a trust and not a sole proprietorship.

Question: What if a one-member LLC makes a check-the-box election to be taxed as a C corporation or an S corporation?

Response: If the LLC is going to be taxed as a C or S corporation, that means that a Form 1120 or 1120S tax return will be filed. In such a case, the LLC should be reported on as an LLC and not as a sole proprietorship.

S. TAX BASIS AND THE "USES TO FILE" CRITERION

Question: An accountant has Company X's December 31, 20X1 tax return on extension and "expects" to file it on the accrual basis of accounting.

On March 18, 20X2, the accountant decides to issue a compilation report on tax-basis financial statements that X prepared on the accrual basis of accounting, which is the method on which the accountant expects to file the tax return.

On October 15, 20X2, the accountant actually files X's income tax return on the cash basis.

Is the fact that the accountant issues tax-basis financial statements on the accrual basis, and then files the tax return on the cash basis, mean that the originally issued financial statements were erroneously issued under the tax basis of accounting?

Response: SSARS No. 21 defines tax basis as "a basis of accounting that the entity *uses to file its income tax return* for the period covered by the financial statements."

At the time the accountant issued the financial statements (March 18, 20X2), presumably the client expected to file the tax return using the accrual basis. The fact that in the end the client changed his or her mind and chose to file the tax return on the cash basis, does not mean that originally the financial statements were improperly prepared using the accrual basis.

Now, this scenario can apply in one year but probably cannot occur from year to year. If the client repeatedly claims it is going to file its tax return on the accrual basis and then actually files it on a cash basis, tax-basis financial statements should be issued on the cash basis, which is the basis the entity uses to prepare its tax return.

As a practical point, the author doubts that any third party is actually going to care whether the income tax-basis financial statements follow the method actually used to file the tax return.

Observation

The author believes that there is a fundamental flaw in the definition of tax-basis financial statements. The definition reflects the format that the entity "uses" to file its income tax return. That means that an entity that uses the cash basis to file its tax return may not be able to use the accrual basis in its tax-basis financial statements.

A better approach would be for a definition of tax-basis financial statements to be changed to reflect financial statements that follow the Internal Revenue Code regardless of whether an entity files an income tax return. Such a change would allow an entity to issue tax-basis financial statements on either a cash or accrual basis, as long as such an approach was authorized by the Internal Revenue Code.

T. TAX-BASIS FINANCIAL STATEMENTS – STATE TAX BASIS OF ACCOUNTING

Question: Company X wishes to issue tax-basis financial statements. Because of the significant amount of depreciation taken for federal income tax purposes (due to Section 179 and bonus depreciation), X wishes to use the tax basis of accounting based on its state income tax laws, not federal tax laws. By using the state tax basis, certain depreciation deductions are not allowed, thereby showing a slightly higher profit.

Is X permitted to issue state tax-basis financial statements?

Response: The definition of "tax basis" is part of a special purpose framework and defined in two sections within accounting and auditing literature:

AU-C 800 and SSARS No. 21 define the tax basis of accounting as:

> *"A basis of accounting that the entity uses to file its income tax return for the period covered by the financial statements."*

Notice that the definition includes the language "income tax return" with no distinction between a federal or state tax return.

Absent language to the contrary, there is no reason why an entity cannot issue tax-basis financial statements using the state tax basis of accounting, provided the entity discloses that fact.

U. SECTION 179 DEPRECIATION – TAX BASIS

Question: Company X is a C Corporation that issues tax-basis (accrual) financial statements.

For year ended December 31, 20X1, X had a Section 179 deduction for fixed asset additions totaling $125,000. X's taxable income before the Section 179 deduction was $75,000.

Because of the taxable income limitation, X was able to use only $75,000 of the Section 179 depreciation, with the remainder $50,000 carried forward unused.

In preparing its 20X1 financial statements on the tax basis of accounting, should X record the entire $125,000 of Section 179 depreciation, or only the $75,000 with a carryover of the remainder $50,000 unused to 20X2?

Response: There is no authority on this particular point.

Although there are instances in which tax-basis financial statements differ from the tax return, those instances are generally limited to non-taxable and non-deductible (permanent) differences. Examples of such non-taxable income and non-deductible items include non-taxable interest, life insurance, meals and entertainment, and penalties, among a few others. Those non-taxable and non-deductible items are permanent differences and are shown on the tax-basis financial statements as income and expense items even though excluded from the tax return. Thus, net income on tax-basis financial statements generally may differ slightly from taxable income per the tax return.

With respect to Section 179 depreciation, the amount of such depreciation shown on the tax-basis financial statements should be the same as the amount deducted on the tax return. Thus, in this example, $75,000 of Section 179 depreciation should be shown on the financial statements with the remaining $50,000 unused, carried over and disclosed. Thus, financial statement net income on a tax basis is zero assuming no permanent differences.

What do you do with the $50,000 depreciation difference on the balance sheet?

In the above example, there is a math problem and a $50,000 item (the unused Section 179 deduction) that results in retained earnings not balancing. If X records the $125,000 of depreciation as a credit to accumulated depreciation, but only deducts $75,000 of depreciation on the tax-basis income statement, how does retained earnings balance for the $50,000 difference?

It doesn't balance. Instead, a balance sheet adjustment must be made to reflect the $50,000 of depreciation not deducted in 20X1. Although there is no authority, the best way to handle the difference is to record only $75,000 of depreciation in accumulated depreciation on the tax-basis financial statements, even though $125,000 is recorded to the Schedule L accumulated depreciation. What this means is that the tax-basis financial statements balance sheet accumulated depreciation will not agree with accumulated depreciation on Schedule L of the tax return. There will be a $50,000 difference.

Observation

If X were an S corporation or partnership, there would be no limit on the deduction of the Section 179 depreciation. Instead, the entire $125,000 of Section 179 depreciation would be recorded on the tax-basis income statement. Thus, by being a C corporation, tax-basis net income is different than tax-basis net income if the entity were an S corporation or a partnership.

Some companies treat the unused Section 179 depreciation as an adjustment to retained earnings, similar to a Schedule M-1 item.

Option 1: Record only the $75,000 of Section 179 depreciation expense on the income statement and carry forward the unused $50,000.

Statement of Income and Retained Earnings- Tax Basis	
Net sales	$XX
Cost of sales	XX
Gross profit on sales	XX
Operating expenses:	
Depreciation	(75,000)
Net income	XX
Retained earnings- tax basis:	
Beginning of year	XX
End of year	**$(75,000)**

Balance Sheet- Tax Basis	
Fixed assets:	
Cost	XX
Less accumulated depreciation	**(75,000)**
Stockholders' equity:	
Common stock,	XX
Retained earnings- tax basis	**(75,000)**

Entry:		
Depreciation	75,000	
AD		75,000

Option 2: Record the $75,000 of Section 179 depreciation expense on the income statement and record the other $50,000 as an adjustment to retained earnings.

Statement of Income and Retained Earnings- Tax Basis	
Net sales	$XX
Cost of sales	XX
Gross profit on sales	XX
Operating expenses:	
Depreciation	**(75,000)**
Net income	XX
Retained earnings (accumulated deficit)- tax basis:	
Beginning of year	XX
Adjustment for additional depreciation	**(50,000)**
End of year	$XX

Balance Sheet- Income Tax Basis	
Fixed assets:	
Cost	XX
Less accumulated depreciation	**(125,000)**
Stockholders' equity:	
Common stock	XX
Retained earnings (accumulated deficit)- tax basis	**(125,000)**

Entry:		
Depreciation	75,000	
Retained earnings	50,000	
AD		125,000

Observation

The author thinks the Option 2 is flawed and should not be followed. After all, the tax basis of accounting should follow the principles and rules for accounting under the federal income tax laws and regulations (or other tax laws and regulations).

That means that the income statement should follow the income tax return, other than permanent differences. Flowing the unused $50,000 of Section 179 deduction through retained earnings appears inconsistent with the principles and rules for accounting under the federal income tax laws and regulations. Of course, there is no authority to address this situation. Following the first option of recording the $75,000 of depreciation only on the income statement and through accumulated depreciation appears to make more sense, even if the accumulated depreciation on the tax-basis balance sheet does not agree with Schedule L balance sheet on the tax return.

V. PRESENTING SECTION 179 AND BONUS DEPRECIATION ON THE TAX-BASIS INCOME STATEMENT

Question: XYZ Company has a large amount of Section 179 and bonus depreciation. XYZ issues income tax-basis financial statements (accrual basis) and is concerned that the large amount of depreciation distorts its income statement.

Is there a way in which XYZ can present the Section 179 and bonus depreciation?

Response: Yes. Because the rules for tax-basis financial statements are limited, the company has flexibility in how depreciation is presented. One way that may be effective is to present Section 179 and bonus depreciation as an other income/deduction item. Following are two examples that illustrate this approach.

Statement of Income and Retained Earnings- Tax Basis
Section 179 and Bonus Depreciation Presented Separate from Other Depreciation
C Corporation

XYZ Company
Statement of Income and Retained Earnings- Tax Basis
For the Year Ended December 31, 20XX

Net sales	$1,200,000
Cost of sales- tax return	800,000
Gross profit	400,000
Deductible expenses:	
Officer's compensation	25,000
Salaries and wages	25,000
Utilities	10,000
Advertising and promotion	5,000
Insurance	2,000
Uncollectible accounts	21,000
Payroll taxes and fringe benefits	12,000
State excise taxes	5,000
Interest	18,000
Depreciation	**20,000**
Sundry other expenses	5,000
Total deductible expenses	148,000
Taxable state income	252,000
State income taxes	(25,000)
Taxable federal income before accelerated depreciation	227,000
Additional first-year depreciation	**(180,000)**
Taxable federal income	47,000**
Non-taxable and non-deductible item:	
Federal income tax expense	(7,500)
Non-deductible life insurance	(12,000)
Non-deductible meals and entertainment	(2,500)
Non-taxable interest	3,000
Net income	28,000
Retained earnings:	
Beginning of year	71,900
End of year	$99,900

** Agrees with line 28 of tax return.

Statement of Income- Tax Basis

Section 179 and Bonus Depreciation Presented Separate from Other Depreciation

[S Corporation]

XYZ Company (An S Corporation)
Statement of Income- Tax Basis
For the Year Ended December 31, 20XX

Net sales	$1,300,000
Cost of sales- tax return	900,000
Gross profit	400,000
Deductible expenses:	
Officer's compensation	25,000
Salaries and wages	25,000
Utilities	10,000
Advertising and promotion	5,000
Insurance	2,000
Uncollectible accounts	21,000
Payroll taxes and fringe benefits	12,000
State excise taxes	5,000
Interest	18,000
Depreciation	**20,000**
Sundry other expenses	5,000
Total deductible expenses	148,000
Taxable ordinary income - state tax purposes	252,000**
State income taxes	(25,000)
Taxable ordinary income	227,000
Other taxable income (deductible expenses):	
Interest	1,000***
Dividends	5,000***
Additional first-year depreciation	**(180,000)*****
Total taxable income	53,000**
Non-taxable and non-deductible item:	
Non-deductible life insurance	(12,000)
Non-deductible meals and entertainment	(2,500)
Non-taxable interest	3,000
Net income	$41,500

** Agrees with Schedule K of Form 1120S.

*** Schedule K items.

W. AGREEMENTS NOT TO COMPETE – TAX-BASIS FINANCIAL STATEMENTS

Question: Company X issues tax-basis financial statements.

In 2007, Company X entered into an agreement not to compete with a party that had a five-year term that has now expired. Yet, the company continues to amortize the agreement over 15 years for tax purposes even though the economic life (five years) has expired.

Is this the correct approach for tax-basis financial statements?

Response: Yes. The company is issuing tax-basis financial statements and thus, is subject to the amortization rules of the Internal Revenue Code which provides for a 15-year amortization under IRC Section 197.

In this case, the company continues to amortize the agreement over 15 years even though the five-year period has expired.

Question: Should the company continue to disclose the terms of the agreement since it has expired but is still being amortized for income tax purposes?

Response: There is no hard and fast rule. Given the fact that the agreement is not in effect, it would appear the disclosure of the terms of the agreement could be eliminated from the disclosure, although the other disclosures related to intangible assets should be included such as:

- Amortization policy
- Amortization expense
- Estimated amortization expense for the five subsequent years
- Gross carrying amount of the intangible asset and accumulated amortization

Following is a sample disclosure related to an agreement not to compete in tax-basis financial statements.

NOTE 1: Summary of Significant Accounting Policies

Agreement not to compete:

Intangible assets consist of an agreement not to compete that is amortized on a straight-line basis over fifteen years in accordance with the Internal Revenue Code.

NOTE 2: Intangible Assets

The following is a summary of intangible assets at December 31, 2014:

	Gross carrying amount	Accumulated amortization
Agreement not to compete	**$300,000**	**$160,000**
	$300,000	$160,000

[optional paragraph]

As a part of its 2007 purchase of the net assets of ABC Manufacturing, the company entered into an agreement not to compete with a key officer of ABC Manufacturing. Under the terms of the agreement, the officer was paid $300,000 in exchange for his agreement not to compete in the business of manufacturing certain products sold by the company for a period of five years through 2011. In accordance with the Internal Revenue Code, the Company is required to continue to amortize the agreement not to compete through year 2021.

Amortization expense was $20,000 in 2014.

Based on intangible assets owned by the Company at December 31, 2014, estimated amortization expense for the five years subsequent to 2014 follows:

Year	Estimated Amortization expense
2015	$20,000
2016	20,000
2017	20,000
2018	20,000
2019	20,000
Beyond 2019	40,000
	$140,000

X. PRESENTING INSOLVENCY IN TAX-BASIS FINANCIAL STATEMENTS

Question: Section 108 of the Internal Revenue Code provides for a portion or all of cancellation of debt (COD) income to be excluded from taxable income under various tests, one of which is the "insolvency exception."

If an entity has Section 108 income that is excluded from taxable income under the insolvency exception, should that income be presented on tax-basis financial statements?

Response: Nothing has been written authoritatively on this matter. However, there are parallel situations that have become generally accepted within tax-basis financial statements, involving nontaxable and nondeductible items (permanent differences).

First, let's understand Section 108.

Section 108 of the IRC deals with cancellation of debt (COD) income. Under Section 108, the amount of COD income recognized is equal to the excess of the amount of debt forgiven over the fair value of the asset.

Section 108 provides certain exclusions under which COD income is excludable from taxable income. One of those exclusions is the insolvency exception.

The insolvency exception states that COD income is excludable from taxable income to the extent that "immediately before the discharge," total liabilities exceed the fair value of total assets. Section 108 also has rules under which an entity (or taxpayer) must reduce its tax attributes (NOLs, credits, etc.) by the amount of excludable COD income.

Insolvency is determined at different levels depending on the type of entity:

- Partnership or LLC: Insolvency is determined at the member or partner level
- S or C corporation: Insolvency is determined at the entity level

Example:

Company X has $1,000,000 of COD income.

Immediately before the discharge of the debt that created the COD income, total liabilities exceeded the fair value of X's assets by $600,000.

Conclusion: $600,000 of the $1,000,000 is excludable from taxable income, while the remaining $400,000 is taxable.

Now to the issue of tax-basis financial statements.

Question: If an entity has COD income, a portion of which is excludable from taxable income, should that excluded income be presented on the income statement of tax-basis financial statements?

Response: Although there is no specific authority dealing with Section 108 COD income, there is similar guidance that has been followed by most practitioners in connection with nontaxable income and nondeductible expenses, otherwise known as permanent differences.

Examples include nondeductible meals and entertainment expense, penalties and fines, life insurance, and nontaxable interest. It has become generally accepted that although these permanent differences are not included on the tax return (and are treated as Schedule M-1 items), tax-basis financial statements include these items as income and expense items. Thus, net income on tax-basis financial statements does not agree with taxable income on the tax return.

Section 108 COD income that is excluded from taxable income is nothing more than a permanent difference, just like other nontaxable income, such as nontaxable municipal interest income.

Thus, the author believes that such excluded COD income should be presented on a statement of income as income under the tax-basis financial statements.

Example: Company X, a C corporation, has the following information for year ended December 31, 20X1:

COD income	$1,000,000
Portion excludable from taxable income under the insolvency exception	(600,000)
Taxable portion of COD income	$400,000

Conclusion: X's statement of income- tax basis would present the COD income as follows:

Option 1: Present the COD income as part of other income, in total

Company X
Statement of Income- Tax Basis
For the Year Ended December 31, 20X1

Net sales	$20,000,000
Cost of sales	15,000,000
Gross profit on sales	5,000,000
Operating expenses	7,000,000
Net operating loss	(2,000,000)
Other income:	
Forgiveness of debt income	**1,000,000**
Interest income	100,000
Net loss before income taxes	(900,000)
Income taxes (credit)	(300,000)
Net loss- tax basis	$(600,000)

Option 2: Present the portion of COD income that is not taxable in a separate section

Company X Statement of Income- Tax Basis For the Year Ended December 31, 20X1	
Net sales	$20,000,000
Cost of sales	15,000,000
Gross profit on sales	5,000,000
Operating expenses	7,000,000
Net operating loss	(2,000,000)
Other income:	
Forgiveness of debt income	**400,000**
Interest income	100,000
Net taxable loss before income taxes	(1,500,000)
Non-taxable items:	
Non-taxable portion of forgiveness of debt income	**600,000**
Net loss before income taxes	(900,000)
Income taxes (credit)	(300,000)
Net loss- tax basis	$(600,000)

TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**Which of the following is correct regarding tax-basis financial statements:** **A.** they have become increasingly more popular with small business clients **B.** they are more time-consuming to prepare than GAAP statements **C.** they are more costly to prepare than accrual basis GAAP statements **D.** they are less meaningful to most closely held businesses
2.	**Tax-basis financial statements can include all of the following except:** **A.** cash method **B.** accrual method **C.** any method that clearly reflects the income under Section 446 of the IRC **D.** regulatory basis
3.	**Which of the following situations is not well suited for tax-basis financial statements:** **A.** when clients are less financially sophisticated **B.** when the owner is actively involved in the day-to-day operations **C.** when a company has high uncollectibles **D.** when a client wants to decrease the cost of preparing a report

4.	**How should taxable income adjustments for prior years' IRS or state audits be treated on tax-basis financial statements:** **A.** charged to income, net of tax **B.** charged to retained earnings **C.** shown pre tax **D.** charged to income and presented as an extraordinary income, net of tax
5.	**Which of the following is correct regarding the disclosure requirements for tax-basis financial statements:** **A.** tax-basis financial statements should include the GAAP disclosures provided they are relevant and applicable to the tax basis of accounting **B.** qualitative information may not be substituted for quantitative information required by GAAP **C.** GAAP disclosure format is required **D.** according to AU-C 800, tax-basis disclosures are essentially required to not be the same relevant disclosures required for GAAP so that the reader is not confused as to whether the financial statements are GAAP
6.	**Which of the following is correct when a company converts from GAAP to tax-basis financial statements:** **A.** there are generally two options for preparing statements in the year of conversion **B.** a change in accounting principle has occurred in accordance with ASC 250 (formerly FASB No. 154) **C.** the change must be shown as an adjustment to beginning retained earnings **D.** there is no adjustment to the beginning balance sheet
7.	**Which of the following is correct regarding an explanatory paragraph identifying the fact that a company changed from GAAP to tax-basis financial statements:** **A.** it is required for an audit report **B.** it is required for a review report **C.** it is required for a compilation report **D.** it is not required, but may be emphasized in a separate paragraph

8.	**When non-GAAP statements are presented, which of the following is correct regarding a statement of cash flows:** **A.** it is required **B.** it is optional **C.** it is discouraged **D.** it is prohibited
9.	**Which of the following is correct regarding the adequacy of disclosure in tax-basis financial statements:** **A.** the basis of accounting note must be thorough to include all differences from GAAP **B.** only a brief description of significant differences in the basis of accounting is required **C.** quantification of the differences between the GAAP and non-GAAP basis of accounting is required **D.** no disclosure of the differences between GAAP and tax basis is required
10.	**Which of the following is correct regarding the use of tax-basis financial statements:** **A.** tax-basis financial statements are always an acceptable alternative to GAAP statements **B.** bank loan documents cannot require GAAP statements **C.** the use of tax-basis financial statements may be a direct violation of bank loan covenant requirements **D.** if bank loan documents require GAAP statements, there is no alternative

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SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** CORRECT. Given the recent wave of complexity that has affected the accounting profession, tax-basis financial statements have become increasingly popular with, in particular, small business clients. **B.** Incorrect. Generally, GAAP statements, not tax-basis financial statements, are more time-consuming to prepare. **C.** Incorrect. Generally, accrual basis GAAP, not tax-basis financial, statements are more costly to prepare. **D.** Incorrect. Because most closely held businesses are tax motivated, usually tax-basis financial statements are more meaningful to such businesses. *(See page 1 of the course material.)*
2.	**A.** Incorrect. Cash basis can be a tax basis if used for tax return purposes. **B.** Incorrect. Accrual basis can be a tax basis if used for tax return purposes. **C.** Incorrect. Tax basis follows the Internal Revenue Code which consists of any method that clearly reflects income. **D.** CORRECT. The regulatory basis, although a special purpose framework, is not tax basis. *(See page 2 of the course material.)*
3.	**A.** Incorrect. Tax-basis financial statements are best used and most meaningful for a less (not more) financially sophisticated client where the client is more tax motivated and interested in cash flows. **B.** Incorrect. Tax-basis financial statements are well suited for a client where the owner is actively involved in the day-to-day operations to ensure that the owner understands the real economics of the business. **C.** CORRECT. The lack of an allowance for bad debts can be a significant problem for some companies with high uncollectibles of receivables. The reason is because tax-basis financial statements do not include an allowance for bad debts. **D.** Incorrect. From both the client and the CPA's perspective, a tax-basis engagement is generally less expensive to conduct than GAAP financial statements. *(See pages 5 to 7 of the course material.)*

4.	**A.** Incorrect. It has become generally accepted that such adjustments should not be presented on the income statement because they relate to prior periods. **B.** CORRECT. The adjustment should be presented as a prior period adjustment through retained earnings, net of tax, because that adjustment pertains to a prior period and not the current period. **C.** Incorrect. Such adjustment, if any, should be net of tax. **D.** Incorrect. Such an item should not be presented as an extraordinary item. Clearly, the adjustment is not infrequent and unusual, which are the two criteria required to present an item as an extraordinary item. *(See page 8 of the course material.)*
5.	**A.** CORRECT. The rules provide that tax-basis financial statements should include the same GAAP disclosures that apply to GAAP if such disclosures are relevant and applicable to tax-basis financial statements. For example, a disclosure of fair value may not be relevant to tax-basis financial statements that do not have fair value measurements. **B.** Incorrect. Qualitative disclosures for tax-basis financial statements may substitute for disclosures. For example, GAAP requires disclosure of the future principal payments on long-term debt over the next five years, but for tax-basis financial statements this disclosure could be satisfied by merely disclosing the repayment terms of significant long-term borrowings without quantifying it in a schedule. **C.** Incorrect. GAAP disclosure format is not required as long as the reader can extract the same information as GAAP statements. **D.** Incorrect. AU-C 800 requires that tax-basis financial statements have disclosures that are similarly informative to those disclosures required by GAAP. There is no concern that the disclosures might confuse the reader that they are GAAP, instead of tax-basis, financial statements. *(See pages 9 to 10 of the course material.)*
6.	**A.** CORRECT. The statements can be presented on a comparative basis by restating the prior year's statements to tax basis, or present only the current year statements. **B.** Incorrect. A change to tax-basis financial statements does not represent a change in accounting principle according to ASC 250 (formerly FASB No. 154) because ASC 250 applies to GAAP statements, not tax-basis financial statements. **C.** Incorrect. When retained earnings are restated, the change can be reflected as an adjustment to beginning retained earnings or as a cumulative-effect of a change on the income statement. The authority for accounting changes found in ASC 250 does not apply. **D.** Incorrect. Typically, the beginning balance sheet must be adjusted. *(See page 39 of the course material.)*

7.	**A.** Incorrect. There is no requirement in the SASs that an explanatory paragraph be included in the audit report noting the change to tax basis. **B.** Incorrect. The SSARSs provide no requirement that an explanatory paragraph be included in a review report when there is a change from GAAP to tax basis. **C.** Incorrect. An explanatory paragraph is not required for a compilation report because the SSARSs include no requirement for such a paragraph. **D.** CORRECT. Although not required, a practitioner may wish to add an explanatory paragraph to his or her report (audit, review, or compilation), identifying the fact that the company changed from GAAP to tax-basis financial statements. If such a paragraph is included in the report, it must also be disclosed in the notes. *(See page 42 of the course material.)*
8.	**A.** Incorrect. A statement of cash flows is not required for non-GAAP (tax-basis) statements. Under GAAP, a statement of cash flows is required only when GAAP statements are presented. **B.** CORRECT. Even though a cash flows statement is not required for non-GAAP financial statements, a company may elect to include a cash flow statement. If such a statement is presented, it must include all the elements required for a typical GAAP statement of cash flows. **C.** Incorrect. Nothing in authoritative literature discourages the use of a cash flows statement for tax-basis (non-GAAP) financial statements. **D.** Incorrect. A cash flows statement is not prohibited in the presentation of non-GAAP (tax-basis) financial statements. *(See page 42 of the course material.)*
9.	**A.** Incorrect. The basis of accounting note may be brief, and not thorough. **B.** CORRECT. The basis of accounting note may be brief, with only the primary differences from GAAP being described. **C.** Incorrect. Quantifying the differences is not required. **D.** Incorrect. A disclosure of the differences is required. *(See page 47 of the course material.)*

10.	**A.** Incorrect. There are situations where GAAP statements are required and tax-basis financial statements are not acceptable. The key determination is whether the third party finds the tax-basis format useful for the intended purpose. **B.** Incorrect. Banks can set their own requirements, and may require GAAP statements. **C.** **CORRECT**. Prior to converting a client to tax-basis financial statements, a practitioner should make sure that such statements are not in violation of the bank loan covenants. For example, some loan documents specifically require GAAP financial statements. **D.** Incorrect. An entity can request a waiver letter from a bank if it wishes to use tax-basis financial statements. *(See page 52 of the course material.)*

GLOSSARY

Available for sale securities – Both debt and equity securities that are not categorized as either held to maturity or trading securities, are automatically categorized as available-for-sale. In this category, management has essentially not decided what it plans to do with the securities.

Cash basis – A basis of accounting that the entity uses to record cash receipts and disbursements and modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets).

Commercial substance – If the future cash flows of the entity are expected to change significantly as a result of an exchange.

Concentration of credit risk – When the entity is exposed to risk of not being diversified with respect to a financial instrument.

Contractual basis – A basis of accounting that the entity uses to comply with an agreement between the entity and one or more third parties other than the auditor.

Debt securities held to maturity – Debt securities that management plans to hold until maturity.

Delayed exchange – Provides investors up to 180 days to purchase replacement property once the relinquished property is sold. The use of a qualified intermediary is required to facilitate a valid delayed exchange.

Impairment – Occurs when the fair value is less than cost.

In-substance common stock – An investment in an entity that has risk and reward characteristics that are substantially similar to that entity's common stock.

Off-balance sheet risk – Potential losses beyond the recorded value on the balance sheet.

Other basis – A basis of accounting that uses a definite set of logical, reasonable criteria that is applied to all material items appearing in the financial statements.

Regulatory basis – A basis of accounting that the entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject.

Substantive kick-out rights – The ability of an investor or another party to remove the decision maker.

Substantive participating rights – The ability to effectively participate in certain actions of the limited partnership.

Tax basis – A basis of accounting that the entity uses to file its income tax return for the period covered by the financial statements.

Tax position – A position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets or liabilities for interim or annual periods.

Trading securities – Both debt and equity securities that are bought and held for the purpose of selling them in the near term (generally within one year).

INDEX

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