Tax-Basis Financial Statements

Course #2141A

Accounting

2 Credit Hours

Support@PacificCPE.com | (800) 787-5313

PacificCPE.com

TAX-BASIS FINANCIAL STATEMENTS

This course covers how to disclose and present tax-basis financial statements.

LEARNING ASSIGNMENTS AND OBJECTIVES

As a result of studying each assignment, you should be able to meet the objectives listed below each individual assignment.

SUBJECTS

Tax-Basis Financial Statements

Study the course materials from pages 1 to 63

Complete the review questions at the end of each chapter

Answer the exam questions 1 to 10

Objectives:

- 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.

Program publication date **03/16/2020**

EXAM OUTLINE

- **TEST FORMAT:** The final exam for this course consists of 10 multiple-choice questions and is based specifically on the information covered in the course materials.

- **ACCESS FINAL EXAM:** Log in to your account and click Take Exam. A copy of the final exam is provided at the end of these course materials for your convenience, however you must submit your answers online to receive credit for the course.

- **LICENSE RENEWAL INFORMATION:** This course qualifies for **2** CPE hours.

- **PROCESSING:** You will receive the score for your final exam immediately after it is submitted. A score of 70% or better is required to pass.

- **CERTIFICATE OF COMPLETION:** Will be available in your account to view online or print. If you do not pass an exam, it can be retaken free of charge.

TABLE OF CONTENTS

TAX-BASIS FINANCIAL STATEMENTS

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.

A. OVERVIEW

Given the wave of complexity that has affected the accounting profession over the past decade, using tax-basis1 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.

B. PRESENT REPORTING AND DISCLOSURE AUTHORITY- TAX BASIS

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

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

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 The previous term "income tax basis" is superseded by the term "tax basis" under new auditing, compilation and review standards.

C. REVISED DEFINITION OF TAX-BASIS FINANCIAL STATEMENTS

Question: What is the revised definition of tax basis?

Response: 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.

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 (OCBOA) 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.

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

Question: When should and entity use and not use tax-basis financial statements?

Response: Tax-basis financial statements should not be used for all entities.

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.

When to use tax-basis financial statements:

Tax-basis financial statements are best used and most meaningful for a company with the following attributes:

- Client is *less financially sophisticated* and more tax motivated and interested in cash flows.
- The owner is *actively involved in the day-to-day operations* to ensure that the owner understands the real economics of the business.
- The company is *strong financially* so that it will not be forced into debt covenant violations by presenting a lower net income.

When not to use tax-basis financial statements:

Tax-basis financial statements *should not be used* in certain situations as follows:

a. They should not be considered where *the financial 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.

   - Not having an allowance for bad debts under the tax basis can be a significant problem for some companies with high uncollectibles.
   - Not recording a contingent liability under the tax basis where an entity has a large contingency for an environmental liability or litigation claim that can distort the financial statements.

Note

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.

b. Tax-basis financial statements should not be used when they are *not acceptable* to a bank or lender, or if they result in violations of loan covenants.