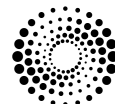


SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's Guide to

Cash, Tax, and Other Bases of Accounting



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Interactive Self-study CPE
Companion to PPC's Guide to
Cash, Tax, and Other Bases of Accounting

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INTRODUCTION

Companion to PPC's Guide to Cash, Tax and Other Bases of Accounting consists of two interactive self-study CPE courses. These are companion courses to PPC's Guide to Cash, Tax and Other Bases of Accounting designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **September 30, 2010**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

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COMPANION TO PPC'S GUIDE TO CASH, TAX, AND OTHER BASES OF ACCOUNTING**COURSE 1****Disclosures in OCBOA Presentations and Reporting on OCBOA Financial Statements (OFSTG091)****OVERVIEW**

COURSE DESCRIPTION:	This interactive self-study course provides an introduction to preparing and reporting on financial statements prepared using other comprehensive bases of accounting. The course discusses general and specific considerations that should be taken into account while using other comprehensive basis of accounting, and applies those considerations to disclosures and reporting requirements.
PUBLICATION/REVISION DATE:	August 2009
RECOMMENDED FOR:	Users of PPC's Guide to Cash, Tax, and Other Bases of Accounting
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of financial statements.
CPE CREDIT:	8 QAS Hours, 8 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours.

FIELD OF STUDY:	Accounting
EXPIRATION DATE:	Postmark by September 30, 2010
KNOWLEDGE LEVEL:	Basic

Learning Objectives:**Lesson 1—Disclosures in OCBOA Presentations**

Completion of this lesson will enable you to:

- Assess issues related to presentation requirements and significant accounting policies OCBOA financial statement presentations.
- Identify financial statement items and other information required to be disclosed by GAAP and how they relate to income tax basis presentations.
- Develop a strategy for dealing with changes in the basis of accounting, omission of substantially all disclosures, consolidation of variable interest entities, and uncertainty in income taxes in tax basis presentations.
- Identify other considerations regarding disclosures in OCBOA presentations such as fair value considerations, presenting consolidated or combined financial statements, and measurement considerations.

Lesson 2—Reporting on OCBOA Financial Statements

Completion of this lesson will enable you to:

- Utilize the general reporting considerations for income tax basis financial statements and determine how compilation and review reports are affected by use of the income tax basis.
- Determine how auditor's reports are affected by use of the income tax basis.
- Identify other reporting situations that should be considered when reporting on OCBOA financial statements.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

**Thomson Reuters
Tax & Accounting—R&G
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Lesson 1: Disclosures in OCBOA Presentations

INTRODUCTION

Authoritative accounting literature does not address other comprehensive bases of accounting or the disclosures necessary in such presentations. Guidance on disclosing information in OCBOA presentations can be found in auditing literature, however. Paragraph 9 of SAS No. 62 (AU 623), *Special Reports*, establishes the overriding criterion that OCBOA financial statements should be “informative of matters that may affect their use, understanding, and interpretation.” Paragraph 10 expands on that by stating that—

- a. the financial statements should include a summary of significant accounting policies that discusses the basis of the presentation and describes how the basis differs from GAAP.
- b. when financial statements contain items the same as, or similar to, those in financial statements prepared in conformity with GAAP, “similar informative disclosures are appropriate.” (To illustrate how to apply that statement, Paragraph 10 states that the disclosures for depreciation, long-term debt, and owners’ equity should be comparable to those in financial statements prepared in conformity with GAAP.)
- c. the auditor also should consider disclosing matters not specifically identified on the face of the statements, such as (1) related party transactions, (2) restrictions on assets and owners’ equity, (3) subsequent events, and (4) uncertainties.

Learning Objectives:

Completion of this lesson will enable you to:

- Assess issues related to presentation requirements and significant accounting policies OCBOA financial statement presentations.
- Identify financial statement items and other information required to be disclosed by GAAP and how they relate to income tax basis presentations.
- Develop a strategy for dealing with changes in the basis of accounting, omission of substantially all disclosures, consolidation of variable interest entities, and uncertainty in income taxes in tax basis presentations.
- Identify other considerations regarding disclosures in OCBOA presentations such as fair value considerations, presenting consolidated or combined financial statements, and measurement considerations.

The guidance in Paragraphs 9 and 10 of SAS No. 62 was based on an interpretation issued in February 1980, *Adequacy of Disclosure in Financial Statements Prepared on a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles*. That interpretation was written with the perspective that, while OCBOA presentations use different measurement principles from GAAP presentations, the disclosures should be the same. The use of wording such as “similar to” and “comparable to” was intended to convey that notion. Nevertheless, a diversity of practice developed over the years. Accountants at one extreme believed disclosures should be included in OCBOA financial statements that were identical to those that would be included in a GAAP presentation. They based their belief on various reasons. For example, some accountants believed that was what SAS No. 62 required, while others believed their peer reviewers would enforce that view of SAS No. 62. Accountants at the other extreme included very little disclosure in OCBOA statements. Typically, they believed users of such statements had different needs from users of GAAP statements. Therefore, they believed including different disclosure was appropriate considering the requirement in Paragraph 9 of SAS No. 62 that the statements should disclose information that may affect their “use, understanding, and interpretation.”

In 1994, the AICPA issued a practice aid, *Preparing and Reporting on Cash- and Tax-Basis Financial Statements*, that included the results of a survey of AICPA Private Companies Practice Section members. The practice aid acknowledged that accountants viewed Paragraphs 9 and 10 of SAS No. 62 differently. For example, on page 11 it said that the issue of disclosure—

. . . is perhaps the most heavily debated issue relating to OCBOA financial statements. Guidance on OCBOA disclosures is contained primarily in AU 623.09 and .10. Those two paragraphs

provide some definitive guidance, but also allow OCBOA financial statement preparers to use considerable judgment in providing informative disclosures that are “appropriate for the basis of accounting used,” or that are “similar” to GAAP disclosures. The terms “appropriate” and “similar” are open to interpretation . . .

In its August 1, 1996 report, the Private Companies Practice Section Special Task Force on Standards Overload recommended that practitioners be provided additional guidance on disclosures to include in OCBOA financial statements. In response to that recommendation, the Audit Issues Task Force (AITF) of the Auditing Standards Board issued an interpretation of Paragraph 10 of SAS No. 62. Interpretation 14 is the fourteenth interpretation of SAS No. 62, and was titled *Evaluating the Adequacy of Disclosure in Financial Statements Prepared on the Cash, Modified Cash, or Income Tax Basis of Accounting*. The AITF originally limited the guidance in the interpretation to financial statements prepared on the cash, modified cash, or income tax basis of accounting because, based on discussions with a variety of accountants, its members believed those bases to be the ones with the most diversity in practice.

In January 2005, the scope of the interpretation was expanded. The new title, *Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity with an Other Comprehensive Basis of Accounting (OCBOA)*, reflects the broadened applicability of the interpretation. The revision changed references to “cash, modified cash, and income tax basis” financial statements to OCBOA financial statements. Therefore, this interpretation now applies to all OCBOA presentations, including financial statements prepared on a regulatory basis.

Revised Interpretation 14 of SAS No. 62 (AU 9623.90–.95) states the following:

- a. The discussion of the basis of presentation required by Paragraph 10 of SAS No. 62 may be brief and only needs to describe the primary differences from GAAP. Quantifying differences is not required.
- b. If the financial statements contain amounts for which GAAP would require disclosure, the statements should either provide the relevant disclosure or provide information that communicates the substance of that disclosure.
- c. If GAAP sets forth requirements that apply to the presentation of financial statements, OCBOA financial statements should either comply with those requirements or provide information that communicates the substance of those requirements.
- d. A statement of cash flows is not required in OCBOA presentations. However, if a presentation of cash receipts and disbursements is presented in a format similar to a statement of cash flows or if the entity chooses to present such a statement, the statement should either conform to the requirements for a GAAP presentation or communicate the substance of the GAAP requirements.
- e. If GAAP would require disclosure of other matters, the need for that same disclosure or disclosure that communicates the substance of those requirements should be considered.

Applicability of Authoritative Literature to Compilation and Review Engagements

Footnote 6 of SSARS No. 1, *Compilation and Review of Financial Statements*, previously made the disclosure guidance in the auditing literature applicable to compiled and reviewed financial statements prepared on an other comprehensive basis of accounting. However, in July 2007, the Accounting and Review Services Committee issued SSARS No. 15, *Elimination of Certain References to Statements on Auditing Standards and Incorporation of Appropriate Guidance Into Statements on Standards for Accounting and Review Services*.

SSARS No. 15 says in Paragraph 1 that it amends SSARS No. 1 “by eliminating certain references to auditing literature and, where deemed appropriate, incorporating guidance similar to that originally referenced.” One of the amendments was to delete footnote 6. As a result of the amendment, SSARS No. 1 now provides no guidance on disclosures in compiled or reviewed financial statements that are prepared on an other comprehensive basis of accounting.

Accordingly, this course is written with the perspective that the adequacy of disclosures in cash, modified cash, or income tax basis financial statements that are compiled or reviewed should continue to be evaluated following the guidance in SAS No. 62 and Interpretation 14.

Guidance for engagements to compile or review OCBOA financial statements continues to evolve. Additional guidance on compilations and reviews of OCBOA financial statements is expected to be issued in the form of a practice aid sometime in 2009. That guidance is not expected to differ significantly from the guidance currently used from SAS No. 62.

Organization of This Lesson

Following the authoritative guidance discussed in the preceding paragraphs, best practices indicate that the disclosures necessary in cash, modified cash, and income tax basis presentations should be evaluated by (a) identifying the disclosures that would be required for a GAAP presentation, (b) deciding whether those disclosures are relevant to the basis of accounting used, and (c) deciding whether the relevant GAAP disclosure requirements should be followed or alternative ways to communicate the substance of those requirements should be explored. To apply this approach, this course addresses the following five aspects of disclosure considerations:

- GAAP presentation requirements and their applicability to cash, modified cash, and income tax basis presentations;
- cash flows information;
- the summary of significant accounting policies;
- financial statement items for which GAAP would require disclosure; and
- other GAAP disclosures and their applicability to OCBOA presentations.

REQUIREMENTS OF PRESENTATION

Some generally accepted accounting principles prescribe how information is to be presented on the face of the financial statements. For example:

- a. SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, (FASB ASC 205-20-45-3) requires that income statements show the results of discontinued operations of a component of an entity net-of-tax as a separate component of income.
- b. SFAS No. 117, *Financial Statements of Not-for-Profit Organizations* (FASB ASC 958-205-45-6), requires voluntary health and welfare organizations to issue a separate financial statement in a matrix format showing expenses according to their natural and functional classifications. It also requires all nonprofit organizations to classify net assets on the statement of financial position into three categories—permanently restricted, temporarily restricted, and unrestricted—and to present information in the statement of activities according to those categories.

Interpretation 14 views accounting principles as falling into two broad categories—measurement and disclosure. Since presentation principles do not affect how amounts are derived, the Interpretation views them as disclosure principles and says that the financial statements should either comply with the requirements for a GAAP presentation or provide information that communicates the substance of those requirements. It also says that the substance of GAAP presentation requirements may be communicated using qualitative information and without modifying the financial statement format. The following paragraphs discuss how the preceding GAAP presentation requirements affect OCBOA presentations in light of the guidance in Interpretation 14.

Extraordinary Items and Disposal of a Component of an Entity

GAAP requires the effects of extraordinary items or disposal of a component of an entity to be reported net-of-tax apart from the results of ordinary operations. Cash, modified cash, or income tax basis financial statements may

present those items in the same manner. Alternatively, they may communicate the objective of the GAAP presentation requirements, which is to separate the effects of those items because of their effect on the comparability of financial statements, without following the GAAP presentation requirements to the letter. For example, the OCBOA financial statements could—

- a. present the results of a disposed component of an entity in a separate column of a cash basis presentation. (As a practical matter, if the information is not readily available, the disposed operations probably do not meet the requirements to be considered a component of the entity.)
- b. provide sufficient information for the financial statement reader to assess the effect of an extraordinary gain from forgiveness of debt by describing it in a note to tax basis financial statements.

Nonprofit Organizations

Cash, modified cash, or income tax basis statements of nonprofit organizations can communicate the substance of the GAAP requirements to provide information about functional expense categories and classes of net assets by (a) presenting a statement of functional expenses (if applicable) and classifying net assets and changes in net assets as unrestricted, temporarily restricted, and permanently restricted or (b) using alternative presentations such as the following:

- The income tax basis statement of activities of a trade organization could present expenses according to natural classifications since that is all that is required in its Form 990. A note to the financial statements could then communicate how expenses are incurred using estimated ratios, such as: “Approximately three-fourths of the Organization’s expenses are incurred in connection with its programs. Program expenses are incurred approximately one-third each to provide continuing education, subsidies to members who are unable to work, and a variety of functions.”
- Instead of presenting the separate financial statement matrix of natural and functional expense classifications, a voluntary health and welfare organization could present expenses in its tax basis statement of activities according to their functional classifications and present the major natural classifications in a note to the financial statements. The information could be taken from the Form 990 matrix.
- The tax basis financial statements of a performing arts organization could present information according to the fund balance approach taken in its Form 990. Information about restrictions and significant changes in restricted amounts could be provided in a note to the financial statements. That information could be provided using general descriptions. For example:

Substantially all of the short-term investments are restricted to completion of the new training facilities, and most of the contributions receivable are restricted to next year’s operations. Contributions raised through the Capital Campaign started towards the end of last year and finished this year funded substantially all of the costs of the new training facilities.

Classification of Assets and Liabilities

GAAP does not require classifying assets and liabilities as current and noncurrent. Neither ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*, chapter 3A (FASB ASC 210-10-45-1) nor SFAS No. 6, *Classification of Short-Term Obligations Expected to be Refinanced*, (FASB ASC 210-10-15-3) requires classified balance sheets; they only say that most entities do so. Cash, modified cash, and income tax basis balance sheets therefore do not need to be classified. As a practical matter, information about liquidity can be provided in ways other than such classifications, such as presenting assets and liabilities in the order of liquidity and through note disclosure.

One Financial Statement Presented

Accountants are sometimes asked to present only one basic financial statement, for example, a statement of assets, liabilities, and equity without a statement of revenues, expenses, and retained earnings. In those situations,

the accountant should present only the disclosures that relate to the financial statement presented. For example, if only a statement of assets, liabilities, and equity is presented, there would be no need to disclose depreciation expense. Also, accountants are sometimes requested to present a full set of basic financial statements for some users and a single financial statement, such as a statement of assets, liabilities, and equity, for others. In that situation, different sets of notes also should be prepared to provide a relevant presentation. Since that only involves eliminating some items from the notes of the full set of financial statements, it should not be costly or time-consuming.

If an entity is reporting on the pure cash basis of accounting, a single statement of cash receipts and disbursements is often used.

As a practical matter, best practices indicate that accountants consider whether readers of the financial statement will be misled by the omission of disclosures that would be provided by inclusion of the other financial statements. That requires judgment based on careful consideration of the facts and circumstances.

Assume that the entity customarily presents a complete set of financial statements presented on the income tax basis and this year incurs a significant loss. If management decides to issue only a statement of financial position prepared on the income tax basis of accounting, the accountant should consider whether omission of disclosure of the loss would mislead the user.

- a. If the omission would not mislead the user, disclosure of the loss is unnecessary. For example, depending on the facts and circumstances, the accountant might conclude that the omission would not mislead the user if either the statement shows a significant accumulated deficit or the statement shows significant retained earnings and the loss is an aberration.
- b. However, the accountant might conclude that, depending on the facts and circumstances, the omission would mislead the user if the entity is likely to continue incurring losses. If the omission would mislead the user, the financial statements should communicate information about the loss.

This guidance also applies if substantially all disclosures are omitted. AR 100.19 permits compiling financial statements that omit substantially all disclosures only if the omission is not intended to mislead. Following the guidance in SSARS No. 1 at AR 100.55, disclosure of the loss solely in the accountant's compilation report would be inappropriate. Instead, the financial statements should disclose the loss, even though substantially all disclosures are omitted. The disclosure could be provided a variety of ways, for example, by disclosing the change in retained earnings in the face of the statement of financial position.

Perhaps more importantly, however, the accountant should carefully consider whether management intended to mislead the users and, if so, whether to continue an association with the client. The accountant should terminate the relationship only after consulting with legal counsel and should carefully phrase the termination notification.

Presentation of Equity Interests the Entity Must Redeem Upon the Owner's Death

SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (FASB ASC 480-10), requires entities to treat as liabilities in their GAAP financial statements three types of financial instruments related to equity interests. Entities that issue OCBOA financial statements are not likely to enter into two of those types, examples of which are put options that require settlement in cash or through the issuance of additional shares.

The third type of financial instrument covered by SFAS No. 150 (FASB ASC 480-10) is one that requires the entity to purchase or redeem equity shares at a particular date or upon an event that is certain to occur. The common agreement by a corporation to redeem an equity interest upon a stockholder's death is an example of this type of financial instrument. Therefore, under SFAS No. 150 (FASB ASC 480-10), stock of corporations that must be redeemed upon the stockholder's death would ordinarily no longer be considered equity under GAAP but instead would be considered a liability.

However, FSP FAS 150-3 (FASB ASC 480-10-65-1 through 65-7; 480-10-5-2; 480-10-5-3), provides a deferral of the requirements of SFAS No. 150 for nonpublic entities. Instruments that are mandatorily redeemable on fixed dates

for amounts that either are fixed or determined by reference to an interest rate index, currency index, or another external index are subject to the requirements of SFAS No. 150 (FASB ASC 480-10). For all other financial instruments that are mandatorily redeemable, the requirements of SFAS No. 150 (FASB ASC 480-10) are deferred indefinitely.

To illustrate, under generally accepted accounting principles, stock of a nonpublic entity redeemable on a fixed date for a prescribed amount would be accounted for as a liability but stock redeemable on the death of the equity holder would be accounted for as equity. *PPC's Guide to Preparing Financial Statements* provides guidance on applying SFAS No. 150 (FASB ASC 480-10) in GAAP financial statements. In most cases, communicating the substance of the information required by SFAS No. 150 (FASB ASC 480-10) only requires a note to the financial statements, or an expansion of the equity caption, that describes the redemption provision.

INFORMATION ABOUT CASH FLOWS

As Interpretation 14 (AU 9623.90–95) notes, presentations using the cash basis of accounting, modified cash basis of accounting, or the cash basis of accounting used for income tax reporting often include a presentation consisting entirely or mainly of cash receipts and disbursements. Such presentations often do not conform to the requirements for a statement of cash flows that would be included in a GAAP presentation. For example:

- a. Cash basis presentations normally show cash receipts and disbursements by major categories. Instead of presenting results in the three categories used in a statement of cash flows—operating, investing, and financing—the statement typically shows all receipts first, then all disbursements.
- b. Modified cash basis income statements typically use a format similar to cash basis presentations but include some noncash transactions along with cash transactions, such as depreciation, and exclude cash transactions that do not affect income such as reduction of long-term obligations.
- c. Presentations using the cash basis of accounting used for income tax reporting generally are similar to either cash basis or modified cash basis presentations.

However, Interpretation 14 requires special considerations if a presentation of cash receipts and disbursements resembles a statement of cash flows. For example, such considerations would be required if a cash basis presentation were grouped according to operating, investing, and financing activities. Similarly, they would be required if a modified cash basis presentation shows an excess of revenue collected over depreciation and interest and other expenses paid, adds depreciation back to that excess to derive cash from operations, and subtracts disbursements for equipment and principal reduction to derive the increase in cash.

If the presentation resembles a statement of cash flows or if the entity decides to include a statement of cash flows, Interpretation 14 requires the presentation to either conform to the requirements for a GAAP presentation or communicate the substance of the GAAP requirements. As a practical matter, the ability to communicate the substance of the requirements for a GAAP presentation generally is limited to disclosure of the major reconciling items between net income and cash from operating activities, disclosure of payments of interest and income taxes, and the presentation of certain transactions gross. As examples, a statement of cash flows included with financial statements prepared on the accrual basis of accounting used for income tax reporting might—

- report the net change in long-term debt in the statement and disclose the cash received from a new obligation in a note describing long-term debt. The note might not disclose principal reductions under the assumption that the financial statement reader could easily determine them.
- use the direct method to report cash flows from operating activities but, rather than present a reconciliation of net income to cash from operating activities, include a note to the financial statements showing the changes in the significant accounts and stating that changes in those accounts comprise most of the difference between net income and cash from operating activities.
- disclose the effect of noncash investing and financing activities through captions in the statement. For example, the investing activities section might have a caption such as “Equipment purchases, less

purchases financed through a \$50,000 loan from First Bank.” Similarly, the financing activities section might have a caption such as “Proceeds from new long-term debt, less \$50,000 to finance equipment purchases.”

SIGNIFICANT ACCOUNTING POLICIES SUMMARIZED

The notes to the financial statements should include a summary of accounting policies that describes the following:

- a. *Basis of Accounting Used to Prepare the Financial Statements.* The description only needs to name the basis; for example:
 - (1) *Cash basis*—“the basis of cash receipts and disbursements”
 - (2) *Modified cash basis*—“the basis of cash receipts and disbursements, with some assets and liabilities recorded” or “the modified cash basis”
 - (3) *Income tax basis*—“the basis of accounting used for federal income tax reporting” or “the accrual basis of accounting for income tax purposes”
- b. *Primary Differences between the Basis of Accounting Used and GAAP.* Generally, the primary differences are those that individually have a material effect on the financial statements. Immaterial differences need not be mentioned. Differences can be identified by looking for items in the statement of financial position that would be accounted for differently under GAAP. SAS No. 62 states that quantifying the effects of differences in the description of the basis is unnecessary. As a practical matter, accountants normally can quickly estimate whether the effect of a difference is likely to be material. If unsure, however, disclosing the nature of the difference is recommended.

Sometimes there may be no material differences between GAAP and the basis used. That may occur, for example, when an entity uses the income tax basis of accounting solely to comply with a partnership agreement or continues to use a modified cash basis that was first used when the differences were material. In that situation, disclosing that there are no material differences is recommended.

Generally, APB Opinion No. 22, *Disclosure of Accounting Policies* (FASB ASC 235-10-50-1), requires an entity to disclose in its GAAP financial statements all of the significant accounting policies used to prepare the statements. In particular, it requires an entity to disclose any of its accounting policies that involve a selection from existing acceptable alternatives, industry peculiarities, and unusual or innovative applications of accounting principles. Other pronouncements also require disclosure of accounting policies.

Typically, the description of the basis can be provided together with the description of other significant accounting policies. If only a few accounting policies are significant, the policies may be described in a single note. If there are too many significant policies to describe in a single note, the policies may be described individually. Often, accounting policies can be described sufficiently through the description of the major differences from GAAP.

Specific Disclosures of Accounting Policies Required by GAAP

Certain GAAP pronouncements specify accounting policies that entities are required to disclose. Examples include a description of depreciation methods required by APB Opinion No. 12, *Omnibus Opinion—1967* (FASB ASC 360-10-50-1), and the policies with respect to accounts receivable. Generally, if the policies are relevant to financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles, disclosures similar to those that would be required by GAAP should be provided.

Disclosure of the Basis of Accounting in Management-use-only Financial Statements

Since management is involved in designing management-use-only financial statements and the financial statements are restricted to management's use, there is no need to identify the particular basis of accounting being used. Nondisclosure of the basis of accounting in compiled management-use-only financial statements can be

addressed in the engagement letter by a statement such as: Material departures from generally accepted accounting principles (GAAP) or other comprehensive basis of accounting (OCBOA) may exist and the effects of those departures, if any, on the financial statements may not be disclosed.

Considerations for Cash Basis Presentations

Cash basis financial statements typically consist of a presentation of cash receipts and disbursements, presenting the difference between the two as the increase or decrease in cash. To illustrate the description of that basis, assume that a trade association presents a statement of cash receipts and disbursements and that the only significant differences from GAAP are that the effects of outstanding dues and obligations for assessments are not reflected. The following disclosure would be appropriate:

The accompanying financial statement has been prepared on the cash receipts and disbursements basis of accounting. Under that basis, the only asset recognized is cash, and no liabilities are recognized. All transactions are recognized as either cash receipts or disbursements, and noncash transactions are not recognized. The cash basis differs from generally accepted accounting principles primarily because the effects of outstanding dues and obligations for assessments are not included in the financial statement.

Typically, only small entities with simple operations use the cash basis for their financial statements. Consequently, there may be situations in which there are no material differences between the cash basis and GAAP. In such cases, accountants have two alternatives—treat the presentation as a statement of operations under GAAP or describe the presentation as showing cash receipts and disbursements but with no significant differences from GAAP.

Considerations for Modified Cash Basis Presentations

The description of the primary differences from GAAP generally provides enough information for the financial statement reader to understand the basis. The following illustrates:

The accompanying financial statements have been prepared on the modified cash basis of accounting. That basis differs from generally accepted accounting principles primarily because the Company has not recognized balances, and the related effects on earnings, of accounts receivable from patients and third-party agencies and of accounts payable to vendors.

Considerations for Income Tax Basis Presentations

Following the accounting principles used for income tax reporting may result in presentations of results that are the same as those on the cash basis or on the modified cash basis, accrual basis presentations with material differences from GAAP, or presentations that do not differ materially from GAAP. Best practices indicate that the description of the accounting basis state whether the basis is the cash or accrual basis of accounting used for tax reporting. In addition, since federal requirements often differ from those for other taxing authorities, disclosing which basis is used often is helpful, such as the “accrual basis of accounting used for federal income tax reporting.” The following illustrates the description for a cash basis taxpayer.

The accompanying financial statements have been prepared on the cash basis of accounting used by the Company for federal income tax purposes. That basis differs from generally accepted accounting principles primarily because receipts of rent in advance are recognized immediately instead of being deferred and because expenses generally are recognized when paid instead of when the underlying obligation is incurred.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. According to the guidance in SAS No. 62, if a company is preparing income tax basis financial statements, which of the following should be considered for inclusion?
 - a. A summary of significant accounting policies discussing the basis of the presentation and its similarities to GAAP.
 - b. Matters that are not identified specifically on the face of the financial statements, such as related-party transactions.
2. Determining if readers of financial statements will be misled by the omission of disclosures provided by inclusion of other financial statements requires judgment based on careful consideration of the facts and circumstances. Which of the following statements regarding the omission of disclosures is most accurate?
 - a. Authoritative literature permits compiling financial statements that omit substantially *all* disclosures.
 - b. SSARS No. 15 states that accountants should disclose the loss solely in the accountant's compilation report.
3. Under SFAS No. 150, there are three types of equity interests that an entity must redeem upon the owner's death. Which financial instrument is most likely to be entered into by entities that issue OCBOA financial statements?
 - a. Put options that require settlement in cash.
 - b. Purchasing/redeeming equity shares at a particular date or upon an event that is certain to occur.
 - c. The issuance of additional shares.
 - d. All three instruments are only viable for entities that issue GAAP financial statements.
4. Which of the following scenarios regarding the summary of significant accounting policies that should be included in the notes of OCBOA financial statements is correct?
 - a. Handy Television Repair discloses the basis of accounting used to prepare the financial statements as, "the accrual basis of accounting for income tax purposes."
 - b. Indy, Inc., uses the income tax basis solely to comply with its partnership agreement, which usually means it has several material differences between the income tax basis and GAAP to disclose.
 - c. Pierce-Shelton discloses the basis of accounting in its management-use-only financial statements.
 - d. Estimating whether the effect of a difference is material is the most time consuming part of preparing Anderson International's income tax basis financial statements.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. According to the guidance in SAS No. 62, if a company is preparing income tax basis financial statements, which of the following should be considered for inclusion? **(Page 3)**
 - a. A summary of significant accounting policies discussing the basis of the presentation and its similarities to GAAP. [This answer is incorrect. The summary of significant accounting policies should discuss how the basis of the presentation differs from GAAP.]
 - b. Matters that are not identified specifically on the face of the financial statements, such as related-party transactions. [This answer is correct. Other such matters include restrictions on assets and owners' equity, uncertainties, and subsequent events.]**
2. Determining if readers of financial statements will be misled by the omission of disclosures provided by inclusion of other financial statements requires judgment based on careful consideration of the facts and circumstances. Which of the following statements regarding the omission of disclosures is most accurate? **(Page 7)**
 - a. Authoritative literature permits compiling financial statements that omit substantially all disclosures. [This answer is correct. AR 100.19 permits compiling financial statements that omit substantially all disclosures. However, the omission cannot be intended to mislead.]**
 - b. SSARS No. 11 states that accountants should disclose the loss solely in the accountant's compilation report. [This answer is incorrect. Following the guidance in SSARS No. 1 at AR 100.55, disclosure of the loss solely in the accountant's compilation report would be inappropriate.]
3. Under SFAS No. 150, there are three types of equity interests that an entity must redeem upon the owner's death. Which financial instrument is most likely to be entered into by entities that issue OCBOA financial statements? **(Page 7)**
 - a. Put options that require settlement in cash. [This answer is incorrect. This financial instrument is treated as a liability by GAAP financial statements, but it is not likely to be entered into by an entity that OCBOA financial statements.]
 - b. Purchasing/redeeming equity shares at a particular date or upon an event that is certain to occur. [This answer is correct. An example of this is stock that must be redeemed at the stockholder's death. Under GAAP, such stock would be viewed as a liability, rather than equity. For OCBOA financial statements, this is viewed as a presentation requirement, so the substance of the required information could be communicated using qualitative information without modifying the format of the financial statements. This would be accomplished by including a note to the financial statements or expanding the equity captions to describe the redemption provision.]**
 - c. The issuance of additional shares. [This answer is incorrect. An entity that presents OCBOA financial statements is not likely to enter into this financial instrument. Under GAAP financial statements, it would be treated as a liability.]
 - d. All three instruments are only viable for entities that issue GAAP financial statements. [This answer is incorrect. Though all would be reflected on GAAP financial statements, there is one financial instrument under SFAS No. 150 that is most likely to be entered into by entities that present OCBOA financial statements.]

4. Which of the following scenarios regarding the summary of significant accounting policies that should be included in the notes of OCBOA financial statements is correct? **(Page 9)**
- a. **Handy Television Repair discloses the basis of accounting used to prepare the financial statements as, “the accrual basis of accounting for income tax purposes.” [This answer is correct. The basis of accounting used should be included in the notes and the description only needs to name the basis. Another example of proper disclosure wording in this same scenario is, “the basis of accounting used for federal income tax reporting.”]**
 - b. Indy, Inc., uses the income tax basis solely to comply with its partnership agreement, which usually means it has several material differences between the income tax basis and GAAP to disclose. [This answer is incorrect. In this instance, there would more likely be no material differences between the GAAP basis and the income tax basis. It is recommended that Indy disclose the fact that there are no material differences.]
 - c. Pierce-Shelton discloses the basis of accounting in its management-use-only financial statements. [This answer is incorrect. Because the statements are restricted to management's use and management was involved in designing the statements, identifying the basis of accounting used is not necessary, however nondisclosure of the basis of accounting in compiled management-use-only financial statements can be addressed in the engagement letter.]
 - d. Estimating whether the effect of a difference is material is the most time consuming part of preparing Anderson International's income tax basis financial statements. [This answer is incorrect. Primary differences between the income tax basis and GAAP should be disclosed in the financial statement notes. They can be identified by looking for items in the statement of financial position that would be accounted for under GAAP differently. Generally, accountants can quickly estimate whether the affect of a difference is likely to be material; though, if unsure, the nature of the disclosure could be made anyway.]

FOR GAAP REQUIREMENTS DISCLOSURE

Following the guidance in Interpretation 14 (AU 9623.90–.95), if OCBOA financial statements contain amounts for which GAAP would require disclosure, the statements should either provide the relevant disclosure that would be required for those amounts in a GAAP presentation or provide information that communicates the substance of that disclosure. Applying that guidance involves (a) identifying financial statement items for which GAAP would require disclosure; (b) deciding whether the GAAP disclosure requirement is relevant to the basis used; and (c) if the requirement is relevant, deciding whether to follow that requirement or to meet the objective of that requirement through other means. Generally, that decision can be made based on efficiency.

Identifying Financial Statement Items for Which GAAP Would Require Disclosure

GAAP prescribes a variety of disclosures for items reported in financial statements, such as the following:

- a. *Amounts.* Examples of amounts that GAAP requires disclosing either in the statements or the accompanying notes are depreciation, interest, rent, and retirement plan expense.
- b. *Components of Amounts.* For example, GAAP requires disclosing the components of property and equipment and the income tax provision.
- c. *Information about Measurement.* Typically, measurement information relates to assets measured at fair value (such as investments in marketable equity securities), assets that have been reduced below their cost (typically through a valuation allowance), or accrued losses.
- d. *Supplemental Fair Value Information.* The disclosures provide information about the fair value of financial instruments reported at cost and those for which amounts are not recorded.
- e. *Information about Transactions Related to the Item.* Examples are descriptions of leasing arrangements when rent income or expense is reported, the scheduled principal reduction of long-term obligations recorded, information about the plan when retirement plan expense is reported, and the terms of related party transactions that lead to amounts reported in the financial statements.
- f. *Other Information about the Item.* An example is the relationship of the tax provision to pretax income.

Financial statement items for which GAAP would require disclosure can be identified by reading the financial statements looking for such items or using a disclosure checklist.

Assessing the GAAP Requirement's Relevance to the Basis of Accounting

The categories of GAAP discussed in the preceding paragraph are as follows:

- a. *Amounts.* If GAAP would require disclosure of an amount recognized by the basis of accounting, best practices indicate that the amount also should be disclosed in the cash, modified cash, or income tax basis financial statements. For example, the GAAP requirement to disclose depreciation expense is relevant to a tax basis presentation of an entity that has depreciable assets because the tax basis financial statements would report depreciation.
- b. *Components of Amounts.* Generally, if GAAP would require disclosing the components of an amount recorded in the financial statements, the components also should be disclosed in cash, modified cash, or income tax basis statements. For example, the components of rental or other property and equipment should be disclosed in tax basis statements or in modified cash basis statements that capitalize property and equipment. However, the GAAP requirement to disclose the components of income taxes is not relevant if deferred taxes are not measured (such as in a cash basis presentation) or are not applicable (such as in an income tax basis presentation).
- c. *Information about Measurement.* Whether the GAAP requirement is relevant depends on whether it relates to the same measurement as in the cash, modified cash, or income tax basis presentation. For example,

the requirement to disclose information about unrealized gains and losses in investments in marketable equity securities is not relevant to a tax basis presentation that measures the investments at their cost. Similarly, requirements to provide information about asset valuation allowances are not relevant to tax basis presentations that only recognize losses when they are realized. (Disclosure about potential losses may be necessary to keep the financial statements from being misleading, however.)

- d. *Supplemental Fair Value Information.* GAAP only requires nonpublic entities to disclose information about the fair value of financial instruments if they have total assets of at least \$100 million on the date of the financial statements or have a financial instrument that, in whole or in part, is accounted for as a derivative instrument during the reporting period. If GAAP would not require the entity to disclose such information in GAAP financial statements, best practices indicate that it is also unnecessary in cash, modified cash, or income tax basis presentations. Otherwise, the authors believe:

- (1) GAAP requirements to provide supplemental fair value information about recorded amounts are relevant to cash, modified cash, and income tax basis presentations. For example, information about the fair value of investments in marketable equity securities recorded at their cost is relevant to tax basis statements. However, while the fair value information that would be required by SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*, (FASB ASC 825-10-50-10) is relevant, the fair value information that would be required by SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FASB ASC 320-10-50), is not relevant since it assumes the investments are measured at fair value.
- (2) GAAP requirements to provide fair value information about financial instruments for which amounts are not recorded are only relevant in financial statements prepared on an accrual basis of accounting, such as that used for federal income tax reporting. The authors believe readers of financial statements prepared with a cash orientation do not expect to see information about unrecorded financial instruments. For example, the reader of a cash basis presentation generally would not expect to see fair value information about a foreign currency option.

SFAS No. 107 (FASB ASC 825-10-50-16) permits not providing fair value information for a financial instrument for which estimating the information is not practicable (that is, if estimating the information is excessive for the benefits it would provide).

- e. *Information about Transactions Related to the Item.* Generally, such requirements are relevant to cash, modified cash, and income tax basis presentations, but that alternate ways often may be used to communicate the substance of the requirements.
- f. *Other Information about the Item.* Generally, whether other information about the item is relevant depends on the basis of accounting. For example, since the reader of cash basis statements should not expect the relationship of income taxes and pretax income to be predictable, the GAAP requirement to disclose the primary reasons for the variance in the relationship is not relevant. On the other hand, even though the amount of rent expense recorded may differ depending on the basis of accounting, the notes to the financial statements should include disclosure of commitments related to long-term lease agreements.

Considerations for Derivatives. SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FASB ASC 815), provides measurement and disclosure requirements for derivative instruments (often referred to simply as derivatives) and hedging activities. Under the definition provided by SFAS No. 133, all derivatives are contracts, but not all derivatives are financial instruments. SFAS No. 133 (FASB ASC 815-10-15-83 through 15-139). All derivatives are required to be measured at their fair value. The accounting for changes in fair value in GAAP financial statements generally varies depending on the purpose for which the entity entered into the derivative. For example, changes in the fair value of derivatives entered into as investments are reported in earnings, but changes in the fair value of derivatives entered into as hedges of risks may be reported in earnings or other comprehensive income, generally depending on the accounting requirements for the hedge. The disclosure requirements of SFAS No. 133 (FASB ASC 815) are consistent with, but more extensive than, those of SFAS No. 107 (FASB ASC 825-10-50-10) for financial instruments.

The requirements of SFAS No. 133 (FASB ASC 815) raise questions about the accounting for derivatives in cash, modified cash, and income tax basis statements. For example, should—

- Derivatives be adjusted to their fair value? If so, how should changes in fair value be presented?
- Disclosures be provided following the requirements of SFAS Nos. 107 (FASB ASC 820-10-50-10) and 133?

Best practices indicate that as a practical matter, entities with significant derivatives transactions are not likely to issue cash or modified cash basis statements for third-party reporting purposes. In the unusual situation in which such an entity issues income tax basis statements, there may not be anything recorded in those statements related to the transactions (such as for certain interest rate swaps). In the event that derivative transactions are recorded in the income tax basis financial statements, best practices indicate that—

- a. Measuring derivatives at their tax bases typically will not result in adjusting them to their fair value.
- b. Following the guidance above, item d, estimating the fair value of derivatives may not be practicable.
- c. The general disclosure requirements of SFAS No. 133 (FASB ASC 815), as amended, that do not relate to the measurement of derivatives at fair value will often be relevant, such as the objectives for holding derivatives, the context needed to understand those objectives, and the entity's strategies for achieving those objectives.

Exploring Alternative Ways to Communicate the Substance of the GAAP Requirement

Whether alternative ways to communicate the substance of the GAAP requirement should be explored usually depends on whether GAAP would require disclosing amounts, such as future cash receipts or disbursements either to reduce long-term obligations or in connection with long-term leases. Alternative ways of communicating may create efficiencies if the answer to any of the following questions is yes:

- a. *Does the Description of the Terms of the Underlying Transactions Already Provide Enough Information?* That may be the case when GAAP requires information about the item's effect on future cash flows. For example, if the entity has only one or two significant long-term obligations, each of which is payable in installments of level principal reduction plus interest, disclosing the repayment terms and the remaining loan period may provide financial statement readers with enough information to understand cash required for future debt reduction. (On the other hand, if an entity has several significant debt obligations, merely disclosing the repayment terms and the remaining loan period may not be sufficient since readers would not be able to determine the effects of future debt reductions without substantial additional effort.)
- b. *Can Significance Be Described Using Adjectives, Ratios, or Percentages Instead of Quantities?* That may be the case when GAAP requires disclosing information about the source of amounts. For example, instead of disclosing the amount of related party sales, their significance might be communicated through a percentage, such as "approximately 30%," a ratio, such as "approximately a third," or through adjectives, such as "substantially all."
- c. *Can Significance Be Described in Relation to Another Financial Statement Amount?* For example, instead of disclosing amounts, the impact of contingent rent on operations might be communicated as a percentage, or range of percentages, of minimum rentals. Similarly, instead of disclosing the amount of uninsured cash balances, a note might say that the risk from concentrating cash credit risk "typically averages between \$50,000 and \$100,000" or, if substantially all cash is deposited in an uninsured investment deposit account, that the risk "approximates the balances reported in the accompanying financial statements."

Considerations for Trade Receivables. The following paragraphs only address application of SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others* (FASB ASC 310-10-50), to the unsecured customer financing that results in the recognition of trade receivables since that is the most common financing activity of entities that issue OCBOA financial statements. *PPC's Guide to Preparing Financial Statements* provides a more thorough discussion.

As a practical matter, however, the disclosure requirements related to accounting for trade receivables and collection losses and to trade receivables that serve as collateral for borrowings are likely to be the only ones relevant to pure cash, modified cash, and income tax basis financial statements.

Disclosure Considerations in Pure Cash Basis Financial Statements. Best practices indicate that the disclosure requirements are not relevant to financial statements prepared on the pure cash basis of accounting since the use of that basis does not result in the recognition of trade receivables.

Disclosure Considerations in Modified Cash Basis Financial Statements. Best practices indicate that recognizing trade receivables is inconsistent with the cash orientation portrayed by the modified cash basis. Accordingly, the disclosure requirements are not relevant to those financial statements.

Disclosure Considerations in Income Tax Basis Financial Statements. In contrast to financial statements prepared using the modified cash basis, income tax basis statements might recognize trade receivables. Best practices indicate that the substance of the disclosure requirements related to accounting for trade receivables and collection losses can be communicated either through the basis of accounting note or through a separate policy note.

The following is an example of a basis of accounting note designed to appropriately communicate the substance of the required information about accounting policies:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

The accompanying financial statements have been prepared on the accrual basis of accounting used by the entity for federal income tax purposes. This basis differs from generally accepted accounting principles primarily because amounts due under trade accounts are reported at the amount outstanding rather than at their estimated net realizable value. Charges to earnings for uncollectible balances are recognized when management has exhausted all reasonable collection efforts.

The following is an example of a separate policy note designed to appropriately communicate the substance of the required information about accounting policies that would be required by the SOP:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Trade Receivables

Trade receivables are reported at the amount of principal outstanding. Balances are written off through charges to earnings only after management has exhausted reasonable collection efforts and concluded that additional collection efforts are not cost-effective.

The disclosure required with respect to the carrying amount of trade receivables that serve as collateral for borrowings can ordinarily be provided by presenting trade receivables as a line item in the financial statements and disclosing the terms of the debt in a note to the financial statements. For example, the following debt disclosure in combination with presentation of the carrying amount of trade accounts receivable as a line item in the financial statements would appropriately disclose the carrying amount of trade receivables pledged as collateral:

NOTE X—DEBT

The short-term note is payable under a \$2,500,000 credit line with First Bank that expires in June 20X8, bears interest at a variable rate based on LIBOR, is secured by trade accounts receivable and inventories, and contains restrictive covenants that primarily relate to financial condition.

Alternatively, appropriate disclosure might be provided through expansion of the line item in the financial statements, such as "Trade accounts receivable, pledged as collateral for the short-term note payable to Community Bank."

Considerations for Guarantees of Debt. FASB Interpretation (FIN) No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FASB ASC 460-10), requires guarantors to record certain guarantees of debt of other parties at their fair value and disclose certain information about their guarantees of debt. Entities that issue OCBOA financial statements rarely guarantee debt of other parties that are not related parties, and those types of guarantees are excluded from the measurement requirements of the guidance. Therefore, for example, an entity that guarantees the debt of another member of a controlled group would not be required to record the guarantee. FIN No. 45 (FASB ASC 460-10-50-1) requires disclosure of all guarantees in a guarantor's financial statements. For guarantees of debt of related parties, FIN No. 45 (FASB ASC 460-10-50-4) generally requires disclosure of the nature of the guarantee and the maximum undiscounted amount of payments the entity could be required to make. Those same disclosures should also be provided in OCBOA financial statements.

GAAP REQUIREMENTS FOR DISCLOSING OTHER INFORMATION

GAAP requires entities to disclose a variety of information that does not relate directly to items reported in GAAP financial statements, such as the following:

- *Going Concern Considerations.*
- *Related Party Transactions for Which Amounts Are Not Recorded.*
- *Commitments and Contingencies.*
- *Uncertainties.*
- *Subsequent Events.*
- *Risks and Uncertainties.*
- *Uncertainty in Tax Positions.*
- *Arrangements with Variable Interest Entities.*

Risks and Uncertainties

SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (FASB ASC 275-10-50-1), offers a variety of disclosure considerations to illustrate how to apply the guidance in Interpretation 14. The GAAP requires providing information about the nature of operations, the general use of estimates, certain significant estimates, and significant concentrations of risk.

- a. *Nature of Operations.* The disclosure provides key operating information to help the financial statement reader better understand the operations. Providing the necessary information typically takes little time and requires few changes in subsequent financial statements.
- b. *General Use of Estimates.* Whether the information is relevant depends on whether the accounting basis uses estimates. While it is not relevant to the pure cash basis, it may be relevant to the modified cash basis, such as when useful lives are estimated for depreciation calculations. The requirement also may be relevant to the income tax basis, such as when estimated direct costs are used to calculate the percentage of completion of contracts.
- c. *Certain Significant Estimates.* The requirement to disclose certain significant estimates is designed to alert financial statement readers to the reasonable possibility that an estimated amount in the current year's statements will change with a material effect on next year's statements.

Some items that require estimates in GAAP financial statements, such as collectibility of amounts due from customers, do not require estimates in income tax basis statements. Although the requirement does not

apply to those amounts, if a material loss is likely on realization of an asset recorded in the financial statements or on settlement of a recorded liability, disclosure of that likelihood may be necessary to keep the statements from being misleading, similar to the discussion in Paragraph 11 of SFAS No. 5, *Accounting for Contingencies* (FASB ASC 450-20-50-9).

- d. *Significant Concentrations of Risk.* The requirement is intended to notify financial statement readers of the reasonable possibility that the loss of a significant customer, supplier, or other concentration will have a severe impact on the entity. As a practical matter, management normally knows whether there are concentrations with such a risk, and the necessary information can be gathered through inquiry. In addition, there is no requirement to quantify the effect. Instead, the significance of the concentration can be conveyed using estimated percentages, such as “approximately 60%,” a ratio, such as “approximately half,” or adjectives, such as “most.”

Going Concern Uncertainty

While the authoritative accounting literature acknowledges that financial statements generally are prepared under the assumption that the reporting entity will continue in existence, it does not address whether that assumption should be reconsidered periodically or whether measurement or disclosure is required if there is uncertainty as to whether the entity will continue in existence. However, SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, requires the auditor to consider the adequacy of disclosure when there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. SAS No. 59 also prescribes considerations in evaluating the adequacy of disclosure of that uncertainty and provides examples of information that might be disclosed. The guidance in SAS No. 59 applies in audits of financial statements prepared using an other comprehensive basis of accounting, as well as those prepared using generally accepted accounting principles.

SSARS No. 17, *Omnibus Statement on Standards for Accounting and Review Services—2008*, issued in February 2008, adds to SSARS No. 1 four new paragraphs (AR 100.69–72) providing guidance on going concern considerations. This is the latest in a series of changes related to going concern considerations in compilation and review engagements. In February 2007, the Accounting and Review Services Committee issued Interpretation No. 29 of SSARS No. 1, *Reporting on an Uncertainty, Including an Uncertainty About an Entity's Ability to Continue as a Going Concern*. Although the Interpretation did not discuss disclosure considerations for going concern uncertainties, it did not change a footnote of SSARS No. 1, which referred accountants evaluating the adequacy of disclosures in compiled and reviewed financial statements to the guidance in SAS No. 59. However, SSARS No. 15, *Elimination of Certain References to Statements on Auditing Standards and Incorporation of Appropriate Guidance Into Statements on Standards for Accounting and Review Services*, issued in July 2007, deleted that referral.

Neither SAS No. 59 nor SSARS No. 1 requires performing procedures specifically designed to determine whether there is uncertainty about the entity's ability to continue as a going concern. Instead, SAS No. 59 requires the auditor to consider whether the audit identified conditions and events that, when considered in the aggregate, indicate there may be uncertainty about the entity's ability to continue as a going concern. SSARS No. 1 (AR 100.69) takes a similar approach, saying that “evidence or information may come to the accountant's attention indicating that there may be uncertainty about the entity's ability to continue as a going concern.” The notion of whether there is uncertainty about the ability to continue as a going concern raises the question of “for how long?” The answer in both SAS No. 59 and SSARS No. 1 is the same—one year from the end of the period being reported on.

The objective of the guidance in SAS No. 59 and SSARS No. 1 is to determine whether the report on the engagement should be modified. Both pronouncements provide for modification if disclosure of the going concern uncertainty is not adequate. Both also discuss including an explanatory (or emphasis of a matter) paragraph in the report, but they take different approaches as to whether such a paragraph is required. SAS No. 59 *requires* including an explanatory paragraph in the auditor's report whenever the auditor concludes that there is substantial doubt about the entity's ability to continue as a going concern, but SSARS No. 1 only notes that the accountant *may* include an emphasis of a matter paragraph in the compilation or review report if there is a going concern uncertainty.

When there is a going concern uncertainty, both the need for report modification for a departure from disclosure accounting principles and an explanatory paragraph must be considered. Examples contrasting the reporting considerations follow.

- a. If audited income tax basis financial statements include adequate disclosure of a going concern uncertainty, report modification for a departure from disclosure accounting principles is obviously not required, but an explanatory paragraph is required. If disclosure of a going concern uncertainty in audited financial statements is not adequate, the auditor's report must both be modified for the departure from disclosure accounting principles for the income tax basis of accounting and include an explanatory paragraph.
- b. If reviewed income tax basis financial statements include adequate disclosure of a going concern uncertainty, report modification for a departure from disclosure accounting principles is obviously not required, and an emphasis paragraph is optional. If disclosure of a going concern uncertainty in reviewed financial statements is not adequate, the accountant's report must be modified for the departure from disclosure accounting principles for the income tax basis of accounting, and an emphasis paragraph is optional.
- c. If compiled financial statements omit substantially all disclosures, report modification for a departure from disclosure accounting principles is obviously not required. An explanatory paragraph could be included in the accountant's report only if the financial statements included disclosure of the going concern uncertainty as selected information.

SAS No. 59 and SSARS No. 1 use different terms to describe when consideration of going concern uncertainty is required. SAS No. 59 looks at whether there is doubt about the ability of the reporting entity to continue as a going concern in terms of whether there is *substantial doubt* about that ability, without defining *substantial doubt*. SSARS No. 1 only looks at whether there is doubt about the ability of the reporting entity to continue as a going concern in terms of whether there is *uncertainty* about that ability.

There are degrees of uncertainty as to whether a condition will continue. For example, SFAS No. 5, *Accounting for Contingencies* (FASB ASC 450-20-25-1), generally looks at uncertainty using three benchmarks—remote, reasonably possible, and probable. While SAS No. 59 does not link substantial doubt with those benchmarks, accountants are used to the notion of substantial doubt.

Since neither the Auditing Standards Board nor the Accounting and Review Services Committee is authorized to prescribe measurement or disclosure requirements, neither SAS No. 59 nor SSARS No. 17 prescribes disclosure requirements for going concern considerations. However, SAS No. 59 provides examples of information that might be disclosed and says that it may be necessary to disclose the principal conditions that raise a question about continued existence and related matters. As an observation, the AICPA has issued Exhibit B in the SSARS Codification that is described as a nonauthoritative exhibit and looks at going concern considerations in compilation and review engagements. The information on disclosure considerations that is in the Exhibit is similar to the guidance in SAS No. 59.

Common questions in considering disclosure of a going concern uncertainty generally relate to when it is necessary and how to word the disclosure. SAS No. 59 notes that uncertainty about an entity's ability to continue as a going concern relates to its inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions. The auditor's evaluation of an entity's ability to continue as a going concern is not merely a matter of evaluating the recoverability, classifications, and amounts of recorded assets and liabilities.

Some users of financial statements interpret going concern disclosures as predicting doom. In fact, many view them as causing a business to fail. Accordingly, the decision to disclose the information should not be taken lightly.

Normally, the disclosure is not provided unless there are serious concerns about the viability of the business. If disclosure is necessary best practices indicate the following:

- a. The disclosure should include all relevant factors, such as:
 - (1) pertinent conditions and events giving rise to the assessment of the entity's ability to continue as a going concern, even if the information is apparent from the financial statements;
 - (2) the possible effects of the conditions and events, management's evaluation of the significance of the conditions and events, and any mitigating factors;
 - (3) management's plans, including possible discontinuance of operations; and
 - (4) information about the recoverability or classification of recorded assets or the amounts or classifications of liabilities
- b. The wording should be neutral and should not be unduly pessimistic or optimistic.
- c. If there are no mitigating factors or management has no specific plans to overcome the conditions, the disclosure should be silent about their absence.

Conditions indicating substantial doubt about the entity's ability to continue as a going concern may not be as evident in pure cash and modified cash basis financial statements as they are in financial statements prepared using generally accepted accounting principles. For example, a statement of cash receipts and disbursements prepared under the pure cash basis may reflect an increase in cash even though the entity has suffered recurring losses. Similarly, if an entity preparing modified cash basis financial statements does not accrue expenses, working capital deficiencies and adverse financial ratios may not be as readily apparent as in a presentation prepared using generally accepted accounting principles. As another example, if the entity does not modify the financial statements to reflect depreciation, the financial results presented in the statement of revenues and expenses might look significantly better than they would under a presentation prepared using generally accepted accounting principles.

Conditions indicating substantial doubt about the entity's ability to continue as a going concern may also not be as evident in income tax basis financial statements as they are in financial statements prepared using generally accepted accounting principles. For example, since a cash basis taxpayer does not accrue expenses, working capital deficiencies and adverse financial ratios may not be as readily apparent as in a presentation prepared using generally accepted accounting principles. Similarly, results under the accrual basis used for income tax reporting will often look better than under generally accepted accounting principles, for example, because those principles would recognize losses before they are deductible for tax purposes or because advance payments are taxable before they are recognized as revenues under generally accepted accounting principles. On the other hand, results under the accrual basis used for income tax reporting could look worse than under generally accepted accounting principles, for example, because the use of accelerated depreciation methods for income tax basis financial statements instead of the straight-line method initially results in losses and retained earnings deficits.

Financial results, including the impact of the basis of accounting on those results, should be considered when determining whether there is substantial doubt about the entity's ability to continue as a going concern for a year after the end of the reporting period. Financial results are just one indicator of a going concern uncertainty, however. Many other conditions could indicate going concern uncertainty. For example:

- *Other Financial Indicators.* Other financial indicators of going concern uncertainty include a default on loan agreements, denial of usual trade credit from suppliers, and the disposal of substantial assets.
- *Internal Matters.* Internal matters that could be indicators of going concern uncertainty include work stoppages or other labor difficulties, substantial dependence on the success of a particular project, and the need to significantly revise operations.
- *External Matters.* External matters that could be indicators of going concern uncertainty include legal proceedings, legislation, or similar matters that might jeopardize an entity's ability to operate; losing a

principal customer or supplier; and an uninsured or underinsured catastrophe such as a drought, earthquake, or flood.

Because the presence of the preceding conditions or events is not impacted by whether the financial statements are presented on the pure cash, modified cash, or income tax basis of accounting or using generally accepted accounting principles, the authors believe it would be rare for the preparation of financial statements using the pure cash, modified cash, or income tax basis of accounting rather than generally accepted accounting principles to affect an accountant's conclusion about an entity's ability to continue as a going concern.

Subsequent Events

The authoritative literature on accounting for subsequent events that is in SFAS No. 165, *Subsequent Events* (FASB ASC 855-10) provides guidance on two types of subsequent events.

- a. The first type, referred to as *recognized subsequent events*, provides additional information about whether an asset was impaired or a liability was incurred at the end of the reporting period. This information should be considered in determining the carrying amount of the asset or liability at the end of the reporting period.
- b. The second type, referred to as *nonrecognized subsequent events*, provides information that does not indicate that an asset was impaired or a liability was incurred at the end of the reporting period but may require disclosure so the financial statements will not be misleading.

To illustrate how to apply the guidance in financial statements prepared using generally accepted accounting principles, assume that at year-end the reporting entity has a significant amount due under a trade account with a major customer that is having financial difficulties. Subsequent to year-end, the reporting entity incurs a substantial uninsured loss on this account. That information should be considered in determining whether a loss should be recognized for impairment of the principal outstanding under the account at year-end.

Now change the illustration so that the customer was not having financial difficulties at year-end, but the customer's difficulties occurred *after* year-end. Although the principal outstanding under the trade account was not impaired at year-end, it may be necessary to disclose the subsequent uninsured loss in order to keep the financial statements from being misleading.

FASB ASC 855-10-50 requires disclosure of the following:

- a. The date through which subsequent events have been evaluated by the reporting entity's management and whether that date is the date the financial statements were issued or the date the financial statements were available to be issued. Note that this disclosure is required regardless of whether an actual subsequent event occurred.
- b. The nature of, an estimate of the financial statement effect of, or a statement that such an estimate cannot be made for subsequent events that are of such a nature that they must be disclosed to keep the financial statements from being misleading (nonrecognized subsequent events.).

TIS 1500.07, *Disclosure Concerning Subsequent Events in Financial Statements Prepared on an Other Comprehensive Basis of Accounting*, clarifies that these disclosures should be made in financial statements prepared on the pure cash, modified cash, or income tax basis of accounting.

FASB ASC 855-10-50-3 also notes that an entity should consider supplementing the historical financial statements with pro forma data or presenting pro forma financial statements if a nonrecognized subsequent event is so significant that disclosure is best made by means of such pro forma financial data.

When financial statements are reissued, events that require disclosure in the reissued financial statements to keep them from being misleading may have occurred subsequent to the original issuance of the financial statements. FASB ASC 855-10-25-4 states that events occurring between the time of original issuance and reissuance of the financial statements should not result in adjustment to the financial statements unless required by GAAP or regulatory requirements.

FASB ASC 855-10-50-4 requires an entity to disclose the date through which subsequent events have been evaluated in both the originally issued financial statements and the reissued financial statements. Best practices indicate this disclosure should also be made in financial statements prepared on the pure cash, modified cash, or income tax basis of accounting in OCBOA financial statements.

Other subsequent events considerations in pure cash, modified cash, and income tax basis financial statements follow.

Subsequent Events Considerations in Income Tax Basis Financial Statements. Whether subsequent events should be considered in measuring assets and liabilities in income tax basis financial statements depends on tax positions the entity takes in its income tax returns. For example, subsequent events would be considered in determining whether a liability should be recognized for expenses deducted under the recurring item exception. To illustrate, assume that an entity offers its customers a warranty and deducts warranty costs following the recurring item exception. Subsequent payments through the period covered by the exception would be considered in measuring the liability for warranty costs at year-end, but other subsequent warranty payments would not be considered.

However, if disclosure of subsequent events is necessary to keep the financial statements from being misleading, the financial statements should either disclose the information that would be required under generally accepted accounting principles or disclose information that communicates the substance of those requirements. For example, disclosure of a subsequent further deterioration of the financial condition of a major customer may be necessary to keep the financial statements from being misleading even if management has not yet determined whether the principal outstanding under the customer's trade account at year-end is worthless. As an observation, the subsequent further deterioration would not be considered in measuring the trade account at year-end because any write-off would only be deductible in the period the account becomes worthless.

Subsequent Events Considerations in Pure Cash and Modified Cash Basis Financial Statements. Since the pure cash basis only recognizes one asset—cash—and it recognizes no liabilities, subsequent events cannot affect the measurements in pure cash basis financial statements. Since modifications of the pure cash basis should generally conform with generally accepted accounting principles, subsequent events should be considered in measuring the assets and liabilities recognized through those modifications.

If disclosure of subsequent events is necessary to keep pure cash or modified cash basis financial statements from being misleading, the financial statements should either disclose the information that would be required under generally accepted accounting principles or disclose information that communicates the substance of those requirements. For example, disclosure of a subsequent event that indicates a material balance due from a customer at year-end is impaired may be necessary to keep the financial statements from being misleading even though customer receivables are not recognized under the modifications of the pure cash basis.

Illustrative Disclosure. An example subsequent events disclosure follows.

NOTE X—SUBSEQUENT EVENT

Events subsequent to December 31, 20X7 have been evaluated through March 18, 20X8, the date these financial statements were available to be issued to determine whether they should be disclosed to keep the financial statements from being misleading. Under an agreement effective February 16, 20X8, a partnership in which the Company has an interest was relieved of future obligations in a real estate joint venture. Substantially all of the Company's investment in the partnership, totaling approximately \$76,000 at December 31, 20X7, will be deemed worthless for federal income tax purposes during 20X8. Management found no other subsequent events that should be disclosed.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

5. Following the guidance in Interpretation 14, if OCBOA financial statements contain amounts for which GAAP would require disclosure, the statements should either provide the relevant disclosure or communicate the substance of that disclosure. Under GAAP, a variety of disclosures are required for items reported in the financial statements. Which of the following is a required GAAP disclosure in the "Amount" category?
 - a. Retirement plan expense.
 - b. Components of property and equipment.
 - c. Accrued losses.
 - d. Leasing arrangements when rent income is reported.
6. Thompson-Wagner presents its financial statements on the income tax basis of accounting. The company has one significant debt obligation, and that obligation is payable in installments of level principal reduction plus interest. How should this be disclosed in the financial statements?
 - a. Because the obligation affects future cash flows, Thompson-Wagner must disclose all the information required by GAAP.
 - b. To create efficiencies, Thompson-Wagner could disclose the repayment terms and the remaining loan period only.
 - c. Thompson-Wagner describes the significance of the obligation using adjectives, ratios, or percentages, which would create efficiencies by not disclosing quantities.
 - d. To create efficiencies, Thompson-Wagner could describe the amount of the obligation in relation to another financial statement amount.
7. GAAP requires disclosure of information that is not directly related to items reported in the GAAP financial statements. Entities that use the income tax basis must evaluate if they should disclose that information, as well. Which of the following is one of those disclosures?
 - a. Going concern considerations.
 - b. Guarantees of debt of unrelated parties.
 - c. Trade receivables.
 - d. Derivatives.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

5. Following the guidance in Interpretation 14, if OCBOA financial statements contain amounts for which GAAP would require disclosure, the statements should either provide the relevant disclosure or communicate the substance of that disclosure. Under GAAP, a variety of disclosures are required for items reported in the financial statements. Which of the following is a required GAAP disclosure in the "Amount" category? **(Page 14)**
 - a. **Retirement plan expense. [This answer is correct. GAAP requires disclosure of retirement plan expense amounts in either the statements or the notes. Other examples include depreciation, interest, and rent.]**
 - b. Components of property and equipment. [This answer is incorrect. This is an example of the GAAP requirement to disclose certain components of amounts.]
 - c. Accrued losses. [This answer is incorrect. GAAP requires disclosure of information about measurement. Typically, this relates to assets that are measured at fair value, those reduced below cost, and accrued losses.]
 - d. Leasing arrangements when rent income is reported. [This answer is incorrect. This is an example of a disclosure of information about transactions related to an item. Another example would be the scheduled principal reduction of long-term obligations recorded.]
6. Thompson-Wagner presents its financial statements on the income tax basis of accounting. The company has one significant debt obligation, and that obligation is payable in installments of level principal reduction plus interest. How should this be disclosed in the financial statements? **(Page 16)**
 - a. Because the obligation affects future cash flows, Thompson-Wagner must disclose all the information required by GAAP. [This answer is incorrect. If Thompson-Wagner has several significant debt obligations, all the GAAP information would be needed so that readers could determine the effects of future debt reductions without substantial additional effort. However, because that is not the case, Thompson-Wagner can create efficiencies by deviating from the GAAP disclosure requirements on its income tax basis statements.]
 - b. **To create efficiencies, Thompson-Wagner could disclose the repayment terms and the remaining loan period only. [This answer is correct. With only one obligation, this disclosure would be sufficient for allowing the readers of the tax basis financial statements to determine the effects of future debt reductions on the cash flows. This will allow the company to create its financial statements more efficiently than if more of the GAAP disclosure requirements had to be met.]**
 - c. Thompson-Wagner describes the significance of the obligation using adjectives, ratios, or percentages, which would create efficiencies by not disclosing quantities. [This answer is incorrect. This would create efficiencies if the company needed to disclose information about the source of amounts, not information about an item's effect on future cash flows.]
 - d. To create efficiencies, Thompson-Wagner could describe the amount of the obligation in relation to another financial statement amount. [This answer is incorrect. This method would not be correct for the applicable scenario. However, for example, if Jacobson-Fink had rental properties, it could disclose contingent rent on operations as a percentage of minimum rentals.]

7. GAAP requires disclosure of information that is not directly related to items reported in the GAAP financial statements. Entities that use the income tax basis must evaluate if they should disclose that information, as well. Which of the following is one of those disclosures? **(Page 18)**
- a. **Going concern considerations.** [This answer is correct. SAS No. 59 requires the auditor to consider the adequacy of disclosure when there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. Other such disclosures include related party transactions for which amounts are not recorded, commitments and contingencies, uncertainties, and subsequent events.]
 - b. Guarantees of debt of unrelated parties. [This answer is incorrect. This would relate to items reported in the GAAP financial statements. FASB Interpretation No. 45 requires guarantors to record certain guarantees of debt of other parties at fair value and also to disclose certain information about their guarantees of debt. However, it would be rare for an entity with income tax basis financial statements to guarantee the debt of other parties that are not related parties.]
 - c. Trade receivables. [This answer is incorrect. Income tax basis financial statements will likely only need to follow disclosure requirements related to accounting for trade receivables and collection losses and to trade receivables that serve as collateral for borrowings. But, if the entity is involved in these activities, it would be related to items reported in the GAAP financial statements.]
 - d. Derivatives. [This answer is incorrect. Derivatives are included as items reported in the GAAP financial statements. SFAS No. 133 provides measurement and disclosure requirements for hedging activities and derivative instruments. Entities with significant derivatives transactions are not believed likely to issue income tax basis financial statements.]

BASIS OF ACCOUNTING CHANGE

Technical Practice Aid TIS 9030.10 views a change in the comprehensive basis of accounting as different from a change in an accounting principle within a comprehensive basis. Therefore, no justification needs to be given for the change. When the effects of the change are material, the only approach for reporting changes is restatement, referred to as retrospective application. The following is one approach to deciding what to do with prior year presentations:

- a. If the basis used in the current year would not have materially changed the results of the prior year, restatement of the prior-year's statements is unnecessary. Instead—
 - (1) if single-year statements are issued, the ending retained earnings balance shown in the prior year's statements could be shown as the opening balance in the current year's statements.
 - (2) if comparative statements are issued, the prior year's statements could be shown as they were originally issued.
- b. If the use of the current basis of accounting would have materially changed the results of the prior year, either—
 - (1) the prior year's statements could be restated using the new basis of accounting and issued in comparison with the current year's statements, or
 - (2) the current year's statements could be issued alone, with the opening balance of retained earnings restated to the current year's basis of accounting.

If the prior year's statements are presented without restatement in comparison with those for the current year, the change in basis of accounting could be disclosed through a note such as the following:

NOTE B—CHANGE IN BASIS OF ACCOUNTING

In previous years, the Company prepared its financial statements using generally accepted accounting principles, which did not yield materially different results from those for income tax reporting. This year, however, the separate calculations required by generally accepted accounting principles for the new leases described in Note X would yield results significantly different from those for income tax reporting. Management believes the results for income tax reporting provide the information needed by the primary users of the financial statements, and the separate calculations required by generally accepted accounting principles for the new leases are therefore not cost-effective. Accordingly, the accompanying 20X1 financial statements are prepared on the income tax basis of accounting. The 20X0 statements presented for comparison are the same as originally issued because using the income tax basis would not have changed them materially.

The note includes the reason for the change in basis of accounting, even though that is not required.

In the situation described in the preceding paragraph, the basis of accounting described in Note A might be as follows:

The accompanying financial statements have been prepared on the basis of accounting used for income tax reporting. In 20X1, that basis differs from generally accepted accounting principles because the Company charges payments under the new leases described in Note X directly to operations instead of accounting for them as financing the acquisition of an asset. In 20X0, there were no substantive differences between the basis used for income tax reporting and generally accepted accounting principles.

The following illustrates the note in comparative financial statements when the statements for the prior year have been restated to the new OCBOA:

In previous years, Taylor Construction prepared its financial statements using generally accepted accounting principles. Since some of those principles differed from the principles used for income tax reporting, Taylor Construction provided deferred taxes for differences between the bases of assets and liabilities for financial statement and income tax reporting. In 20X1, it adopted the basis of accounting used for income tax reporting as the basis for its financial statements. The accompanying 20X0 financial statements have been restated to conform with the new basis of accounting. Because of the differences from generally accepted accounting principles described in Note A, retained earnings at the beginning of 20X0 are approximately \$50,000 lower, net income for 20X0 is approximately \$10,000 lower, and retained earnings at the end of 20X0 are approximately \$60,000 lower than the amounts previously reported.

OMISSION OF SUBSTANTIALLY ALL DISCLOSURES

Ordinarily the accountant's compilation report on financial statements that were prepared using a comprehensive basis of accounting other than generally accepted accounting principles should specifically address, as a departure from the requirements of the basis of accounting, each omitted disclosure of which the accountant is aware. However, SSARS No. 1 provides an exception to that requirement when the financial statements omit substantially all of the disclosures that would ordinarily be included in the financial statements. (SSARS No. 15 did not change that exception.) In that situation, the accountant's compilation report need only address the overall omission of substantially all disclosures, without mentioning specific omissions. As SSARS No. 1 notes, that general exception applies to the omission of disclosures that might appear in the body of the financial statements as well as those that might appear in separate notes to the financial statements.

SSARS No. 1 (AR 100.20) notes that the only disclosure that can never be omitted is the use of a comprehensive basis of accounting other than generally accepted accounting principles; substantially all other disclosures can be omitted. For example, information about the capital structure may be omitted, regardless of whether that information would otherwise be presented as part of the equity caption in the statement of assets, liabilities, and equity or in a note to the financial statements. Similarly, the financial statements might be more condensed than they would be for full disclosure presentations. For example, an entity might choose not to show changes in retained earnings or other components of equity and might show major components of expenses, such as selling expenses and administrative expenses, but none of the accounts included in those components.

Nevertheless, management may choose to provide disclosures that might otherwise be omitted. For example, management may decide that, while disclosure of other accounting policies will be omitted, the use of the gross profit method to estimate inventories in the interim financial statements will be a helpful reminder for the primary users of the financial statements. SSARS No. 1 provides two methods of providing such disclosures. They may be provided through expansion of financial statement captions, such as "inventories, estimated using the gross profit method," or through the addition of a note following the financial statements. When notes are added, SSARS No. 1 requires appropriately labeling them, for example, "Selected Information—Substantially All Disclosures Ordinarily Included in Financial Statements Prepared on the Income Tax Basis of Accounting Are Not Included."

CONSOLIDATION OF VARIABLE INTEREST ENTITIES FIN 46

A Look at the Authoritative Literature

In December 2003, the FASB reissued FASB Interpretation No. (FIN) 46 (generally referred to as FIN 46(R)) (FASB ASC 810-10). In June 2009, the FASB issued SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)*. Those amendments become effective the first annual reporting period that begins after November 15, 2009. As of the date of this Course, the FASB Codification does not include SFAS No. 167.

The authoritative literature on accounting for a variable interest in a variable interest entity generally requires the reporting entity to consider whether the financial results of related party entities should be included in its consolidated financial statements. The next few paragraphs provide an overview of considering that requirement in the preparation of financial statements using generally accepted accounting principles. The overview is designed to provide background information for determining whether the measurement and disclosure principles of the authoritative literature on accounting for a variable interest in a variable interest entity should be considered in preparing

pure cash, modified cash, and income tax basis financial statements. That literature is complex and difficult to understand, even for seasoned accountants. *PPC's Guide to Related Parties (Including Variable Interest Entities)* provides detailed guidance.

Consideration of the authoritative literature on accounting for a variable interest in a variable interest entity is required if there are certain related party relationships. Generally, those relationships involve a related party entity, and there will be no effect on the financial statements of a small or midsize nonpublic reporting entity if—

- a. the reporting entity, its related parties, or both *did not participate* significantly in the design or redesign of another entity;
- b. another entity *is not designed* so that substantially all of its activities either involve or are conducted on behalf of the reporting entity and its related parties; *and*
- c. the reporting entity, its related parties, or both *do not provide* more than half the equity, subordinated debt, or other forms of financial support of another entity.

Even if at least one of the relationships exists, the authoritative literature on accounting for a variable interest in a variable interest entity will have no effect on the financial statements of the reporting entity if—

- a. the other entity is not a variable interest entity *or*
- b. the reporting entity does not have a variable interest in the entity.

A variable interest is a contractual, ownership, or other pecuniary interest whose fair value changes with changes in the fair value of the entity's net assets. An entity is a variable interest entity if its equity is not sufficient or its equity investors do not have certain characteristics.

If at least one of the relationships exists, the authoritative literature on accounting for a variable interest in a variable interest entity will require the reporting entity to include the consolidated financial results of the other entity in its financial statements and provide certain disclosures if—

- a. the other entity is a variable interest entity,
- b. the reporting entity has a variable interest in the entity, *and*
- c. the reporting entity is the primary beneficiary of the entity.

Generally, the reporting entity is the primary beneficiary of a variable interest entity if the reporting entity has the power to direct the activities of the entity that most significantly impact its economic performance *and has either* the obligation to absorb losses that could be significant to the entity *or* the right to receive benefits that could be significant to the entity.

In addition, if at least one of the relationships exists, GAAP generally will require the reporting entity to provide certain disclosures, but not consolidate, if—

- a. the other entity is a variable interest entity,
- b. the reporting entity has a variable interest in the entity, *and*
- c. the reporting entity is not the primary beneficiary of the entity.

If the reporting entity is the primary beneficiary of a variable interest entity the consolidated statement of financial position should present separately certain information about the variable interest entity and disclose information about the variable interest entity whose financial results are consolidated. If the reporting entity holds a variable interest in a variable interest entity but is not its primary beneficiary, GAAP requires disclosing information about the relationship and the risk exposure the reporting entity has because of the relationship.

Considering the Measurement Principles of FIN 46

The requirements of the authoritative literature on accounting for a variable interest in a variable interest entity for determining whether consolidation is required in financial statements prepared using generally accepted accounting principles are not relevant to determining whether to present consolidated income tax basis financial statements. Consolidated income tax basis financial statements can be presented only if the reporting entity presents consolidated income tax returns. Consolidation of income tax returns is an election that generally is available only in prescribed circumstances. This view is confirmed by Technical Practice Aid TIS 1500.06, *Application of FASB Interpretation No. 46(R), "Consolidation of Variable Interest Entities," to Income Tax Basis Financial Statements*.

The consolidation requirements of the authoritative literature on accounting for a variable interest in a variable interest entity also do not apply to pure cash basis financial statements, and they only apply to modified cash basis financial statements if one of the modifications of the pure cash basis is consolidation. As a practical matter, however, small and midsize nonpublic entities that present modified cash basis financial statements are not likely to elect consolidation as a modification.

Considering Whether There Is a Difference from Generally Accepted Accounting Principles Because of the Requirements for Accounting for a Variable Interest in a Variable Interest Entity

SAS No. 62 requires financial statements prepared on the pure cash, modified cash, or income tax basis of accounting to describe how the basis differs from generally accepted accounting principles. Some small and midsize nonpublic entities that present pure cash, modified cash, or income tax basis financial statements have determined that the authoritative literature on accounting for a variable interest in a variable interest entity would require consolidation if their financial statements were instead prepared using generally accepted accounting principles.

For example, some entities that previously prepared their financial statements using generally accepted accounting principles elected to begin preparing their financial statements using the income tax basis of accounting when they determined that the authoritative literature on accounting for a variable interest in a variable interest entity would require consolidation. They were concerned that consolidated financial statements would not provide the information about specific entities that lenders need for evaluating lending arrangements. The entities also noted that lenders were willing to accept income tax returns from some of the entities whose financial results would need to be converted to generally accepted accounting principles for inclusion in the consolidated financial statements.

Determining whether the authoritative literature on accounting for a variable interest in a variable interest entity causes a difference between generally accepted accounting principles and the basis of accounting used to prepare the financial statements requires determining whether that authoritative literature would require consolidation. Neither SAS No. 62 nor the related Interpretation 14 imposes on the reporting entity the requirement to determine whether consolidation would be required.

If the reporting entity knows that consolidation would be required, the absence of consolidation should be disclosed as a difference between the basis of accounting used and generally accepted accounting principles. The following illustrates appropriate disclosure in the financial statements of ABC Company when the authoritative literature on accounting for a variable interest in a variable interest entity would require including in its financial statements the consolidated financial results of DEF Company. The illustrative disclosure is designed to follow the description of other differences.

In addition, generally accepted accounting principles would require consolidating in the financial statements the financial results of DEF Company.

If the reporting entity has not determined whether consolidation is required, best practices indicate considering whether a relatively straightforward determination could be made. For example, it may not be necessary for the reporting entity to determine whether it has a variable interest in a related party entity and if so whether the related party entity is a variable interest entity. Instead, the reporting entity may be able to look at whether consolidation would be required under the assumptions that the reporting entity has a variable interest in the related party entity

and that the entity is a variable interest entity. Depending on the facts and circumstances, the reporting entity may conclude that—

- a. the individual who is the majority equity investor in both the reporting entity and the related party entity is more closely associated with the related party entity, and
- b. therefore, GAAP would not require the reporting entity to include the financial results of the related party entity in its consolidated financial statements.

If a relatively straightforward determination cannot be made, best practices indicate that the reporting entity should consider if there is a reasonable possibility that consolidation would be required.

- a. If there is a reasonable possibility that consolidation would be required, the authors recommend that the reporting entity disclose that generally accepted accounting principles may require consolidation. The following illustrates appropriate disclosure in the financial statements of ABC Company when there is a reasonable possibility that the authoritative literature on accounting for a variable interest in a variable interest entity would require including in its consolidated financial statements the financial results of DEF Company. The illustrative disclosure is designed to follow the description of other differences.

In addition, generally accepted accounting principles may require consolidating in the financial statements the financial results of DEF Company.

- b. If there is not a reasonable possibility that consolidation would be required, best practices recommend not mentioning the possibility that generally accepted accounting principles might require consolidation.

Considering the Disclosures Requirements of the Authoritative Literature on Accounting for a Variable Interest in a Variable Interest Entity

The authoritative literature on accounting for a variable interest in a variable interest entity prescribes presentation and disclosure requirements for when the reporting entity is the primary beneficiary of a variable interest entity and disclosure requirements for when the reporting entity has a variable interest in a variable interest entity but is not its primary beneficiary.

The disclosures required about consolidated financial results are not relevant when consolidated financial statements are not presented. Determining whether the disclosure requirements for when the reporting entity has a variable interest in a variable interest entity but is not its primary beneficiary are directly applicable to pure cash, modified cash, or income tax basis financial statements requires the reporting entity to determine whether it has a relationship with an entity that is a variable interest entity, whether the reporting entity has a variable interest in that entity, and whether the reporting entity is the primary beneficiary of that entity. Those determinations often require exercising considerable judgment, and neither SAS No. 62 nor the related Interpretation 14 requires the reporting entity to make those determinations.

The disclosures required when the reporting entity has a variable interest in a variable interest entity but is not its primary beneficiary generally look at the risk a related party relationship presents for the reporting entity. The authoritative literature on accounting for contingencies that is in FASB ASC 450-20-50-9 notes that disclosure of loss contingencies may be necessary to keep the financial statements from being misleading. Generally, the disclosure requirements of the authoritative literature on accounting for a variable interest in a variable interest entity when the reporting entity has a variable interest in a variable interest entity but is not its primary beneficiary should be evaluated in that context, and accordingly pure cash, modified cash, and income tax basis financial statements should either provide the relevant disclosures that would be required or provide information that communicates the substance of those required disclosures.

To illustrate information that communicates the substance of the relevant disclosures required, assume that—

- a. ABC Company is the reporting entity,
- b. Lane Samuels owns substantially all the equity of ABC Company and owns all the equity of DEF Company,

- c. ABC Company leases its operating facilities from DEF Company,
- d. Lane guarantees the bank debt of DEF Company, and
- e. the carrying amount of that debt is \$700,000.

The following illustrates appropriate disclosure by ABC Company of information that communicates the substance of the disclosures that would be required under generally accepted accounting principles.

Since 20X1, ABC Company has leased its operating facilities from DEF Company under a lease that is renewed annually. The real estate and the related bank debt comprise most of the carrying amount of the assets and liabilities of DEF Company. Lane Samuels, who owns substantially all of the equity of ABC Company, owns all of the equity of DEF Company and guarantees the debt of DEF Company. The carrying amount of that debt at the end of the year was \$700,000.

Parent-Entity Financial Statements

Some accountants questioned whether a reporting entity could issue financial statements as a parent company, typically referred to as parent-entity financial statements, instead of consolidating under the authoritative literature on accounting for a variable interest in a variable interest entity. However, the authoritative consolidation accounting literature in FASB ASC 810-10-45-11 says that parent-entity financial statements are not a valid substitute for consolidated financial statements.

However, the issue of whether a reporting entity can present parent-company financial statements in lieu of consolidated financial statements is not relevant to pure cash, modified cash, or income tax basis financial statements.

- a. Since there is no requirement for consolidation to be a modification of the pure cash basis, the issue of whether a reporting entity can present parent-company pure cash or modified cash basis financial statements to avoid a requirement to consolidate is not relevant.
- b. Since the measurement principles in income tax basis financial statements are the ones used to prepare the reporting entity's income tax returns, an entity that files consolidated tax returns cannot issue parent-company income tax basis financial statements.

ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES

A Look at the Interpretation

Depending on the facts and circumstances, there may be varying views on the appropriate income tax treatment of a transaction. Therefore, there may be uncertainty about whether a tax position would be sustained by the taxing authority if it examined the position.

Nevertheless, most accountants have not viewed FASB Statement No. 109, *Accounting for Income Taxes* (FASB ASC 740-10), as requiring the consideration of uncertainty about tax positions in computing current and deferred tax assets and liabilities. Generally, as long as the entity had appropriate support for the tax positions it has taken or intends to take, the positions would be accepted as the basis for the computations of current and deferred tax assets and liabilities under SFAS No. 109 (FASB ASC 740-10).

FASB Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes*, requires a different approach to calculations under SFAS No. 109 (FASB ASC 740-10). The Interpretation requires that computations of current and deferred income tax assets and liabilities should only consider tax positions that, more likely than not, would be sustained if the taxing authority examined the positions. For this purpose, the phrase "more likely than not" means that there is greater than a 50 percent chance.

FIN 48 (FASB ASC 740-19) requires a two-step approach to recognizing tax benefits: determining whether a tax benefit should be recognized and looking at how to measure a tax benefit that is recognized. Whether a tax benefit

should be recognized depends on whether the benefit is, or will be, derived from a tax position that meets the “more likely than not” criterion. A tax benefit should only be recognized if the tax position meets the criterion. The entity must assess the likelihood that a tax position would be sustained by assuming that the taxing authority will examine the return in which the position is, or will be, taken, and that the taxing authority will examine the position. The guidance prohibits considering the possibility that a return may not be examined and that, even if a return is examined, the position may not be examined.

The recognized tax benefit should be measured as the largest amount of tax benefit for which there is greater than a 50 percent chance of realization “upon ultimate settlement with a taxing authority that has full knowledge of all relevant information.” The largest amount of tax benefit should be determined using facts and circumstances available and should consider likely outcomes.

To illustrate, assume that an entity develops a tax position under which it will claim a deduction for an expense. If the entity believes there is *no more than a 50 percent chance* the taxing authority would accept the position, the entity should recognize no tax benefit from the deduction in its financial statements. However, if the entity believes there is *greater than a 50 percent chance* the taxing authority would accept the position, the entity should recognize the tax benefit for which there is greater than a 50 percent chance of realization upon settlement with the taxing authority.

If the entity believes there is greater than a 50 percent chance the full deduction would be allowed, the tax benefit of the full deduction should be recognized. However, if the entity believes it would likely settle with the taxing authority by agreeing to a deduction for less than the full amount originally deducted, or that the taxing authority would disallow part of the deduction, the entity should recognize a tax benefit for only the portion of the deduction expected to be ultimately accepted. That amount can be determined qualitatively or quantitatively:

- a. A *qualitative* assessment could be made a variety of ways. For example, it could be made based on the accountant's experience with comparable situations, or based on the accountant's understanding of the direction rulings by the taxing authority tend to take.
- b. A *quantitative* assessment could be made based on different probability scenarios under which the amount recognized is the largest amount above a cumulative probability greater than 50 percent.

FIN 48 (FASB ASC 740-10-50) requires providing for the effect of penalties and interest on the liability for tax benefits that have been realized but have not been recognized. Some entities include penalties and interest related to income taxes in the tax provision and other entities include them in expenses. Either approach is permitted but disclosure of which approach the entity uses is required. Also requires disclosure of the amounts of penalties and interest related to income taxes that are recognized in the statement of results of operations and the amounts recognized in the statement of financial position must be disclosed.

Prior guidance on disclosures required for uncertainty in income taxes was provided primarily by SFAS No. 5, *Accounting for Contingencies* (FASB ASC 450-20-50), and SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (FASB ASC 275-10). FIN 48 amends SFAS No. 5 to remove uncertainty in income taxes from the scope of SFAS No. 5. However, FIN 48 (FASB ASC 740-10) does not modify SOP 94-6 (FASB ASC 275-10). As a practical matter, however, Paragraphs B60 and B61 of the Background Information and Basis for Conclusions of FIN 48 suggest that the FASB believes the required disclosures provide financial statement users with sufficient information about uncertainty in income taxes. For example, Paragraph B61 says, “The Board decided that codifying and enumerating required disclosures in this Interpretation will increase comparability and reduce complexity.” That provides evidence that separate consideration of SOP 94-6 (FASB ASC 275-10) is not required for disclosures of uncertainty in income taxes.

FIN 48 (FASB ASC 740-10-50-15) requires the financial statements to provide a tabular reconciliation of the total amounts of unrecognized tax benefits as of the beginning and end of the period. Also the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate should be disclosed. For example, depending on the facts and circumstances, a note to the financial statements might say—

The entity deducted the payment of a loss incurred this year. While the entity believes there is a realistic possibility the deduction would be allowed if examined by the taxing authority, there is

nevertheless the possibility that it would not be allowed. Because of that uncertainty, the entity has not recognized the estimated tax benefit from claiming the deduction in this year's return. Instead, the entity has provided a liability for unrecognized tax benefit of \$80,000 for the additional tax that would be assessed if the deduction were disallowed. The liability is classified as noncurrent because the entity does not anticipate settling it within the next year.

The entity's policy for the presentation of penalties and interest related to income taxes can be disclosed in a variety of ways. For example, the disclosure could be provided in a policy note, such as, "Penalties and interest assessed by income taxing authorities are included in operating expenses." However, disclosure of penalties and interest as line items in the financial statements also discloses the entity's presentation policy. The amounts of penalties and interest related to income taxes may be disclosed either in the financial statements themselves or in a note to the financial statements.

FIN 48 (FASB ASC 740-10-50-15) also requires describing tax years that remain subject to examination by major tax jurisdictions, as the following illustrates.

The federal income tax returns of the Company for 20X1, 20X2, and 20X3 are subject to examination by the IRS, generally for three years after they were filed.

Effective Date. FIN 48 (FASB ASC 740-10) was issued in June 2006 and was effective originally for fiscal years beginning after December 15, 2006. However, FASB Staff Position (FSP) FIN 48-3, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, (FASB ASC 740-10-15-2A) permits nonpublic entities to defer application of the guidance until annual periods beginning after December 15, 2008. In addition, FSP FIN 48-3 (FASB ASC 740-10-65-1) requires reporting entities that defer FIN 48 for calendar year 2008 to disclose this fact and the accounting policy for evaluating uncertain tax positions for each set of financial statements where the deferral applies.

Proposed Amendments. In May 2009, the FASB released proposed FSP FIN 48-d, *Application Guidance for Pass-through Entities and Tax-Exempt Not-for-Profit Entities and Disclosure Modifications for Nonpublic Entities*, which would amend FIN 48 (FASB ASC 740-10) to provide guidance for pass-through entities and not-for-profit organizations and eliminate certain disclosure requirements for all nonpublic entities.

The significant amendments resulting from the proposed guidance are as follows:

- All entities are subject to FIN 48 (FASB ASC 740-10) even if the only tax position in question is the entity's status as a pass-through entity or tax-exempt not-for-profit organization, and even if it is more likely than not that the entity's status would be sustained upon examination.
- The determination of whether income taxes are attributable to the entity or its owners must be based on the laws and regulations of the taxing authority, rather than who actually pays the taxes as agreed to between the entity and its owners.
- Consolidated or combined financial statements must include all tax positions for each entity within the group that is subject to income taxes or that has taxable income assigned to it from a pass-through entity.
- Nonpublic entities will not be required to present a tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period, or to disclose the total amount of unrecognized tax benefits that, if recognized, would affect the effective income tax rate.

For entities that have already adopted FIN 48 (FASB ASC 740-10), the amendments are expected to be effective upon issuance. For all other entities, the expected effective date is for periods ending after September 15, 2009.

Consideration of Uncertainty in Income Taxes in Income Tax Basis Financial Statements

Measurement Principles. The measurement principles used to prepare income tax basis financial statements are determined solely by the measurement principles used to prepare the income tax return. Therefore, the tax provision reported in income tax basis financial statements is the amount of income taxes reported in the income tax returns.

Disclosure of the Primary Differences from Generally Accepted Accounting Principles. SAS No. 62 requires financial statements prepared on the income tax basis of accounting to describe how the basis differs from generally accepted accounting principles. Depending on the facts and circumstances, the reporting entity may be able to readily determine whether the measurement of income taxes in income tax basis financial statements would differ materially from the GAAP requirements. Many small and midsize nonpublic entities incur taxable income primarily through routine business transactions, and their deductions are based on clear and unambiguous tax law.

In those situations, the entity is highly confident that there is far better than a 50% chance that the deductions would be sustained under examination. FIN 48 (FASB ASC 740-10-25-6) only requires that the probability be greater than 50%. Therefore, under generally accepted accounting principles, the amount of income taxes reported in the tax return would be reported as the current tax provision in the financial statements, and generally there would be no difference from the amount reported in the income tax basis statements.

Small and midsize nonpublic entities that know there is risk in their position on the deductibility of certain expenses typically have estimated the probability of an unfavorable outcome as part of their analysis of which tax position to take. However, all that is needed to determine whether there is a difference between the amount of income taxes reported in income tax basis financial statements and the amount that FIN 48 would require reporting is a determination of whether the chance that the position would be sustained upon examination is greater than 50%.

- a. If the chance is greater than 50%, there is no difference between the tax provision reported in income tax basis financial statements and the amount FIN 48 (FASB ASC 740-10) would require reporting.
- b. Otherwise, there is a difference between the tax provision reported in income tax basis financial statements and the amount FIN 48 (FASB ASC 740-10) would require reporting, and, if the difference would likely be material, disclosure of the difference is required.

The following provides an example of appropriate disclosure added after the description of other significant differences.

In addition, income taxes are reported at the amount reported in the income tax returns. Under generally accepted accounting principles, the amount reported would be based on probability assessments of the likelihood that certain deductions would be disallowed upon examination because the taxing authorities interpreted existing guidance differently.

Required Disclosures. Generally, Interpretation 14 of SAS No. 62 distinguishes between two categories of disclosure requirements under generally accepted accounting principles: disclosures required for items in the financial statements and disclosures required for other matters. Since the disclosures required by FIN 48 (FASB ASC 740-10) relate to an item reported in income tax basis financial statements—income taxes—they fall into the first category of disclosures required by Interpretation 14. The financial statements should either provide the disclosure required by FIN 48 (FASB ASC 740-10) or provide information that communicates the substance of the required disclosure.

- a. The required disclosures about unrecognized tax benefits are not relevant because the amount of income taxes reported in the financial statements is the amount reported in the tax returns. Therefore, there can be no unrecognized tax benefits.
- b. The requirement to disclose the entity's policy for the presentation of interest and penalties related to income taxes is not relevant to income tax basis financial statements. For tax reporting, deductions for interest and penalties are included in expenses considered in computing taxable income rather than being included in income taxes.
- c. The requirement to disclose the amounts of interest and penalties related to income taxes is relevant. Those amounts may be disclosed either in the financial statements themselves or in a note to the financial statements.
- d. The requirement to disclose the tax years that remain subject to examination by major tax jurisdictions is relevant. For example, a note to the financial statements could say—

The federal income tax returns of the Company for 20X1, 20X2, and 20X3 are subject to examination by the IRS, generally for three years after they were filed.

Consideration of Uncertainty in Income Taxes in Cash and Modified Cash Basis Financial Statements

Applying the Step Approach in Modifying the Pure Cash Basis to Recognize Income Tax Assets and Liabilities. Modifications of the pure cash basis of accounting must conform with generally accepted accounting principles; they must make sense, and they must not be so extensive that the presentation becomes in substance a presentation prepared using generally accepted accounting principles. Best practices indicate limiting use of the modified cash basis to entities whose operations are:

- oriented toward cash receipts and disbursements,
- not significantly influenced by financing of sales or purchases, and
- relatively simple and do not have complexities (such as manufacturing, development, or other conversion activities or common acquisitions of property and equipment) that require significant modifications.

Under the pure cash basis, income taxes are reported as the amount paid or received during the period, with payments of income taxes reported as cash disbursements and receipts of income tax refunds reported as cash receipts. Assets are not recognized for overpayments of income taxes, and liabilities are not recognized for income taxes due. Depending on the facts and circumstances, an entity may therefore elect to modify the pure cash basis to recognize income tax assets and liabilities. Applying the step approach to recognizing income tax assets and liabilities in modified cash basis financial statements raises two questions:

- a. Does the modification require recognizing both current and deferred income tax assets and liabilities?
- b. Should FIN 48, *Accounting for Uncertainty in Income Taxes* (FASB ASC 740-10), be considered in measuring the income tax assets and liabilities recognized?

Does a Modification to Recognize Income Tax Assets and Liabilities Require Recognizing Both Current and Deferred Income Tax Assets and Liabilities? The carrying amounts of assets and liabilities recognized in modified cash basis financial statements may differ from their basis for income tax reporting. For example, a decision to modify the pure cash basis to capitalize and depreciate the cost of equipment may result in depreciating the cost slower in the financial statements than in the income tax returns.

Current, but Not Deferred, Income Tax Assets and Liabilities Are Recognized. To illustrate facts and circumstances that may lead the entity to conclude that it will modify the pure cash basis to recognize current, but not deferred, income tax assets and liabilities, assume that the entity prepares its financial statements using the pure cash basis modified to recognize, but not depreciate, an asset for its operating real estate, to recognize a liability for the related debt, and to recognize income tax assets and liabilities. The entity plans to hold the real estate for the foreseeable future and believes the primary users of the financial statements are not concerned about the difference between the gain that would be recognized for financial statement and income tax reporting of the ultimate disposition of the property. In this set of facts and circumstances, the entity would likely conclude that only recognizing current income tax assets and liabilities is sufficient for its reporting purposes and that recognizing the deferred income tax liability for the taxable difference in accounting for the real estate is unnecessary.

Both Current and Deferred Income Tax Assets and Liabilities Are Recognized. To illustrate facts and circumstances that may lead the entity to conclude that it will modify the pure cash basis to recognize both current and deferred income tax assets and liabilities, assume that the entity prepares its financial statements using the pure cash basis modified to recognize investments in debt and equity securities and the unrealized appreciation and depreciation in their fair value and to recognize income tax assets and liabilities. The entity believes the primary users of the financial statements are mainly interested in cash flow consequences and that the financial statements should clearly communicate that realizing changes in the fair value of the securities would have tax implications that would alter cash flows. In this set of facts and circumstances, the entity would likely conclude that recognizing both current and deferred income tax assets and liabilities is relevant to the primary users of the financial statements.

Disclosure of the Primary Differences from Generally Accepted Accounting Principles. SAS No. 62 requires financial statements prepared on the pure cash or modified cash basis of accounting to describe how the basis differs from generally accepted accounting principles. In pure cash basis financial statements, a generic description ordinarily is sufficient to describe the primary differences from generally accepted accounting principles. If modifications to the pure cash basis do not include recognizing accrued income taxes, there may be a difference between the income taxes reported in the financial statements and the amounts that FIN 48 (FASB ASC 740-10) would require reporting.

Disclosures Required by FIN 48 (FASB ASC 740-10-50). Generally, Interpretation 14 of SAS No. 62 distinguishes between two categories of disclosure requirements under generally accepted accounting principles: disclosures required for items in the financial statements and disclosures required for other matters. Since the disclosures required by FIN 48 (FASB ASC 740-10-50) relate to an item reported in cash or modified cash basis financial statements—income taxes—they fall into the first category of disclosures required by Interpretation 14.

- a. The required disclosures about unrecognized tax benefits are not relevant to pure cash basis financial statements, and they are only relevant to modified cash basis financial statements if one of the modifications is to recognize the effects of accrued income taxes. The financial statements should either provide the disclosure required by FIN 48 (FASB ASC 740-10-50) or provide information that communicates the substance of the required disclosure. As an illustration, the following would communicate the substance of the disclosure that FIN 48 (FASB ASC 740-10-50) would require if the entity prepares modified cash basis financial statements that recognize accrued income taxes.

The tax provision reported in the accompanying financial statements is greater than the amount of income tax reported in the income tax return. The \$16,000 excess is the reduction of income tax reported in the tax return that arose from a deduction that might be disallowed if the IRS examines the tax return and interprets existing guidance differently than the Company interprets it. The tax benefit from the deduction was not recognized in the financial statements. There is a reasonable possibility guidance will be provided within the next year that provides additional evidence as to whether the deduction would be allowed upon examination.

- b. The requirement to disclose the entity's policy for the presentation of interest and penalties related to income taxes is relevant to pure cash basis and modified cash basis financial statements. That disclosure can be provided a variety of ways. For example, the disclosure could be provided in a policy note, such as, "Interest and penalties assessed by income taxing authorities are included in operating expenses." However, disclosure of interest and penalties as line items in the financial statements also discloses the entity's presentation policy.
- c. The requirement to disclose the amounts of interest and penalties related to income taxes is relevant, and those amounts may be disclosed either in the financial statements themselves or in a note to the financial statements.
- d. The requirement to disclose the tax years that remain subject to examination by major tax jurisdictions is relevant. For example, the notes to the financial statements could say—

The federal income tax returns of the Company for 20X1, 20X2, and 20X3 are subject to examination by the IRS, generally for three years after they were filed.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

8. Go Green Company (GGC) changes its comprehensive basis of accounting from the cash basis to the income tax basis in 2009. The change did not materially change the 2008 results. Which of the following best illustrates the options suggested in the course that GGC can use for dealing with the 2008 presentations?
 - a. GGC could restate the 2008 financial statements using the income tax basis and issue them in comparison with the 2009 statements.
 - b. GGC can issue the 2009 statements alone, but the opening balance of retained earnings must be restated to the income tax basis of accounting.
 - c. GGC must issue comparative statements that show the 2008 statements as originally issued.
 - d. GGC can show the 2008 ending retained earnings balance as the opening balance of the 2009 financial statements.
9. The Carnegie Corporation (the reporting entity) significantly participated in the design of Phillips-Jones, Inc.; however, the Carnegie Corporation does **not** have a variable interest in Phillips-Jones. Does authoritative literature on accounting for a variable interest in a variable interest entity apply?
 - a. Yes.
 - b. No.
 - c. It is a matter of professional judgment.
10. Dress City is a small, nonpublic business entity that uses the income tax basis of accounting. Its related party, Super Slacks, might be considered a variable interest entity under FIN 46. How should Dress City proceed?
 - a. Dress City is required by FIN 46 to determine if Super Slacks is a variable interest entity, and, if it is, the consolidation requirements apply in their entirety.
 - b. Dress City is required by SAS No. 62 to determine if Super Slacks is a variable interest entity, and, if it is, Dress City must disclose the fact that not consolidating is a departure from GAAP.
 - c. Dress City is not required to determine if Super Slacks is a variable interest entity, but best practices indicate a disclosure if the determination is straightforward or if consolidation is reasonably likely.
11. FIN 48 requires a two-step approach to recognizing tax benefits. Which of the following steps is derived from the tax position that meets the "more likely than not" criterion?
 - a. Determining if a tax benefit should be recognized.
 - b. Determining how to measure a tax benefit that is recognized.
12. Which of the following scenarios correctly applies FIN 48's approach to recognizing tax benefits?
 - a. While assessing the likelihood that its tax position will be sustained, Star-Backs decides that there is a significant possibility that its return will not be examined and that, even if the return is examined, its position on a specific item may not be examined.
 - b. Manny's Market claims a deduction for an expense on its tax return. The Market believes that there is a 50% chance that the taxing authority will accept its position; therefore it recognizes the tax benefit in its financial statement.

- c. Kite Enterprises believes that it would settle on a lesser amount for a tax deduction if the deduction was examined by the taxing authority. To determine the amount to be recognized quantitatively, probability scenarios are run and the largest amount above a cumulative probability greater than 50% is recognized.
 - d. Dale-Hammons has appropriate support for the tax positions that it intends to take; therefore, the company uses those positions as the basis for computations of current and deferred tax assets and liabilities.
13. Which of the following best describes how FIN 48 applies to income tax basis financial statements?
- a. The measurement principles of FIN 48 always apply to pure income tax basis financial statements.
 - b. The measurement principles of FIN 48 apply only if the resulting amount differs significantly from the amount of income tax reported.
 - c. The measurement principles of FIN 48 never apply to income tax basis financial statements.
14. When applying the step approach and modifying cash basis financial statements, modifications of the pure cash basis of accounting must conform with generally accepted accounting principles: they must make sense, and must not be so extensive that the presentation becomes, in substance, a presentation prepared using generally accepted accounting principles. Best practices indicate that entities should limit the use of the modified cash basis to entities whose operations are all of the following **except**:
- a. Significantly influenced by financing of sales or purchases.
 - b. Directed toward cash receipts and disbursements.
 - c. Simple and do not have complexities.
15. Which of the following is relevant to both the pure cash basis and the modified cash basis financial statements?
- a. Required FIN 48 disclosures regarding unrecognized tax benefits.
 - b. Required FIN 48 disclosures of the entity's policy for presentation of interest and penalties.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

8. Go Green Company (GGC) changes its comprehensive basis of accounting from the cash basis to the income tax basis in 2009. The change did not materially change the 2008 results. Which of the following best illustrates the options suggested in the course that GGC can use for dealing with the 2008 presentations? **(Page 28)**
- a. GGC could restate the 2008 financial statements using the income tax basis and issue them in comparison with the 2009 statements. [This answer is incorrect. GGC should consider this option if the income tax basis materially changes the results of the 2008 statements.]
 - b. GGC can issue the 2009 statements alone, but the opening balance of retained earnings must be restated to the income tax basis of accounting. [This answer is incorrect. If the income tax basis materially changes the results of the 2008 statements, GGC should consider this option.]
 - c. GGC must issue comparative statements that show the 2008 statements as originally issued. [This answer is incorrect. GGC does not have to issue comparative statements. It can still issue single-year statements. However, if it chooses to issue comparative statements, then this option should be used.]
 - d. **GGC can show the 2008 ending retained earnings balance as the opening balance of the 2009 financial statements. [This answer is correct. A change in the comprehensive basis of accounting is viewed by Technical Practice Aid TIS 9030.10 as different from a change in an accounting principle within a comprehensive basis, so no justification needs to be given for the change. Furthermore, because the effects of the change are not material, restating the prior year's statements is unnecessary.]**
9. The Carnegie Corporation (the reporting entity) significantly participated in the design of Phillips-Jones, Inc.; however, the Carnegie Corporation does **not** have a variable interest in Phillips-Jones. Does authoritative literature on accounting for a variable interest in a variable interest entity apply? **(Page 30)**
- a. Yes. [This answer is incorrect. If a reporting entity or its related parties significantly participated in the design of another entity, generally FIN 46 will have an effect. However, there are other conditions that, if they exist, might change things.]
 - b. **No. [This answer is correct. Though significantly participating in the design of Phillips-Jones would seem to make the authoritative literature apply to the Carnegie Corporation, the fact that the Carnegie Corporation does not have a variable interest in Phillips-Jones means that, generally, the authoritative literature will have no effect.]**
 - c. It is a matter of professional judgment. [This answer is incorrect. Consideration of the authoritative literature is required if at least one of four conditions listed in its Paragraph 4h exists. Therefore, it is not a matter of professional judgment.]
10. Dress City is a small, nonpublic business entity that uses the income tax basis of accounting. Its related party, Super Slacks, might be considered a variable interest entity under FIN 46. How should Dress City proceed? **(Page 31)**
- a. Dress City is required by GAAP to determine if Super Slacks is a variable interest entity, and, if it is, the consolidation requirements apply in their entirety. [This answer is incorrect. FIN 46 does not require a reporting entity like Dress City to determine if consolidation would be required.]
 - b. Dress City is required by SAS No. 62 to determine if Super Slacks is a variable interest entity, and, if it is, Dress City must disclose the fact that not consolidating is a departure from GAAP. [This answer is incorrect. SAS No. 62 does not impose the requirement that Dress City determine if consolidation is required.]

- c. **Dress City is not required to determine if Super Slacks is a variable interest entity, but best practices indicate a disclosure if the determination is straightforward or if consolidation is reasonably likely. [This answer is correct. If Dress City knew that consolidation of Super Slacks was required, that should be disclosed as a departure from GAAP. Since Dress City does not know in this scenario, finding out is not required by GAAP. However, if the determination would be straightforward or if there is a reasonable possibility that consolidation would be required, including the information in a disclosure is a best practice.]**
11. FIN 48 requires a two-step approach to recognizing tax benefits. Which of the following steps is derived from the tax position that meets the “more likely than not” criterion? **(Page 34)**
- a. **Determining if a tax benefit should be recognized. [This answer is correct. Whether a tax benefit should be recognized depends on if the benefit is, or will be, derived from a tax position that meets the “more likely than not” criterion. The tax benefit should only be recognized if the tax position meets the criterion.]**
- b. Determining how to measure a tax benefit that is recognized. [This answer is incorrect. Recognized tax benefits should be measured as the largest amount of tax benefit for which there is greater than 50% chance of realization “upon ultimate settlement with a taxing authority that has full knowledge of all relevant information.” Thus, it is not necessary for this step to meet the “more likely than not” criterion.]
12. Which of the following scenarios correctly applies FIN 48’s approach to recognizing tax benefits? **(Page 34)**
- a. While assessing the likelihood that its tax position will be sustained, Star-Backs decides that there is a significant possibility that its return will not be examined and that, even if the return is examined, its position on a specific item may not be examined. [This answer is incorrect. Under FIN 48, it is prohibited for Star-Backs to consider the possibility that a return may not be examined or that a position on the return may not be examined even if the return is examined.]
- b. Manny’s Market claims a deduction for an expense on its tax return. The Market believes that there is a 50% chance that the taxing authority will accept its position; therefore it recognizes the tax benefit in its financial statement. [This answer is incorrect. Under FIN 48, Manny’s Market is only allowed to recognize the tax benefits of a position that has a *greater than 50%* likelihood of being accepted by the taxing authority, so in this case the market cannot recognize the benefit of the deduction on its financial statements.]
- c. **Kite Enterprises believes that it would settle on a lesser amount for a tax deduction if the deduction was examined by the taxing authority. To determine the amount to be recognized quantitatively, probability scenarios are run and the largest amount above a cumulative probability greater than 50% is recognized. [This answer is correct. If Kite Enterprises chooses to, the company could also determine the amount qualitatively, which includes a variety of methods, such as basing the decision on the accountant’s experience with comparable situations.]**
- d. Dale-Hammons has appropriate support for the tax positions that it intends to take; therefore, the company uses those positions as the basis for computations of current and deferred tax assets and liabilities. [This answer is incorrect. Dale-Hammons has used the method found under SFAS No. 109. FIN 48 requires a different approach.]
13. Which of the following best describes how FIN 48 applies to income tax basis financial statements? **(Page 36)**
- a. The measurement principles of FIN 48 always apply to pure income tax basis financial statements. [This answer is incorrect. The measurement principles used to prepare financial statements prepared on the income tax basis of accounting are determined by the measurement principles used to prepare the company’s income tax return.]
- b. The measurement principles of FIN 48 apply only if the resulting amount differs significantly from the amount of income tax reported. [This answer is incorrect. For income tax basis financial statements, the income tax provision reported is the amount of income taxes reported in the income tax returns. FIN 48 would not apply in this situation.]

- c. **The measurement principles of FIN 48 never apply to income tax basis financial statements. [This answer is correct. However, if the difference in the amount of the tax provision reported in the income tax basis statements differs significantly than what would be reported using FIN 48, the difference should be disclosed.]**
14. When applying the step approach and modifying cash basis financial statements, modifications of the pure cash basis of accounting must conform with generally accepted accounting principles: they must make sense, and must not be so extensive that the presentation becomes, in substance, a presentation prepared using generally accepted accounting principles. Best practices indicate that entities should limit the use of the modified cash basis to entities whose operations are all of the following **except: (Page 37)**
- a. **Significantly influenced by financing of sales or purchases. [This answer is correct. Best practices indicate that entities limit the use of the modified cash basis to entities whose operations are not significantly influenced by financing of sales or purchases.]**
 - b. Directed toward cash receipts and disbursements. [This answer is incorrect. Best practices indicate that entities should limit the use of the modified cash basis to entities whose operations are oriented toward cash receipts and disbursements.]
 - c. Simple and do not have complexities. [This answer is incorrect. Best practices indicate that entities should limit the use of the modified cash basis to entities whose operations are relatively simple and do not have complexities (such as manufacturing, development, or other conversion activities or common acquisitions of property and equipment) that require significant modifications.]
15. Which of the following is relevant to both the pure cash basis and the modified cash basis financial statements? **(Page 38)**
- a. Required FIN 48 disclosures regarding unrecognized tax benefits. [This answer is incorrect. The required disclosures about unrecognized tax benefits are only relevant to modified cash basis financial statements if one of the modifications is to recognize the effects of accrued income taxes. However, the required disclosures about unrecognized tax benefits are not relevant to pure cash basis financial statements.]
 - b. **Required FIN 48 disclosures of the entity's policy for presentation of interest and penalties. [This answer is correct. The requirement of FIN 48 to disclose the entity's policy for the presentation of interest and penalties related to income taxes is relevant to pure cash basis and modified cash basis financial statements. That disclosure can be provided a variety of ways. For example, the disclosure could be provided in a policy note, such as, "interest and penalties assessed by income taxing authorities are included in operating expenses." However, disclosure of interest and penalties as line items in the financial statements also discloses the entity's presentation policy.]**

OTHER CONSIDERATIONS

Presentation of Sales and Similar Taxes in the Statement of Results of Operations

Entities often collect taxes (such as sales, use, value added, and certain excise taxes) from customers and send the amounts collected to the appropriate taxing authority. EITF Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)* (FASB ASC 605-45-50-3; 605-45-50-4), addresses the presentation of such taxes in the statement of results of operations. (FASB ASC 605-45-50-3 and 50-4) and EITF Issue 06-3 (FASB ASC 605-45-15-2) applies to any tax a governmental authority assesses that is imposed on and occurs simultaneously with a specific transaction between a seller and a customer that produces revenue. It does not apply to certain tax schemes imposed during the inventory procurement process.

Currently, some entities present sales and similar taxes on a gross basis. That is, they record the amount of taxes collected as revenues and the amount remitted to taxing authorities as costs. Other entities use a net presentation offsetting the taxes against the related revenues. EITF 06-3 (FASB ASC 605-45-45) allows either presentation method and gives factors to consider when selecting a presentation method. The presentation chosen is an accounting policy decision to be disclosed in accordance with APB Opinion No. 22, *Disclosure of Accounting Policies* (FASB ASC 235-10-50-1). However, entities that report sales and similar taxes on a gross basis must disclose the amount of those taxes if they are significant. Such disclosure may be done on an aggregate basis.

Fair Value Considerations

A Look at SFAS No. 157. SFAS No. 157, *Fair Value Measurements* (FASB ASC 820) defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, and expands disclosures about fair value measurements.

SFAS No. 157 (FASB ASC 820-10-20) defines fair value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” The guidance applies to recurring and nonrecurring measurements at fair value but does not change when those measurements are required, either to determine amounts to report in the face of the financial statements or to determine amounts to disclose. For example—

- a. SFAS No. 107 (FASB ASC 825-10-50) still requires disclosure of the fair value of financial instruments unless the entity is a nonpublic entity, its assets are less than \$100 million, and it has no derivatives.
- b. SFAS No. 115 (FASB ASC 320-10-10) still requires investments in equity securities that are available for sale and for which fair value is readily determinable to be measured at their fair value on a recurring basis.
- c. SFAS No. 142 (FASB ASC 350) still requires a nonrecurring adjustment of the carrying amount of intangible assets to their fair value to recognize an impairment loss.

Instead of prescribing when fair value measurements are required, the measurement guidance in SFAS No. 157 (FASB ASC 820-10) looks at how fair value should be determined when generally accepted accounting principles require fair value measurement. The guidance accomplishes that by providing a fair value hierarchy consisting of three levels—levels 1, 2, and 3—generally ranging from the most objective determination of fair value to the most subjective.

- a. Level 1 measurements use quoted prices in active markets for *identical* assets or liabilities that the reporting entity has the ability to access at the measurement date.
- b. Level 2 measurements generally use available indirect information, such as quoted prices for *similar* assets or liabilities in active markets, or quoted prices for identical or similar assets or liabilities in markets that are not active.
- c. Level 3 measurements are the most subjective, generally based on the entity's own assumptions developed using the best information available in the circumstances.

Fair value measurements generally should be based on the most objective information available. For example, level 1 measurements should be used whenever possible, and level 3 measurements should only be used when level 1 or level 2 measurements cannot be made. This three-level hierarchy should accommodate most fair value measurements of small and midsize nonpublic entities. However, the authoritative literature acknowledges the possibility that, depending on the facts and circumstances, it may not be practicable to determine the fair value of certain financial instruments.

The disclosures required by SFAS No. 157 (FASB ASC 820-10-50) generally are designed to enable users of financial statements to assess how fair values are determined. The required disclosures are grouped into two categories, those for recurring fair value measurements and those for nonrecurring measurements.

- a. Each category generally requires disclosure of the related assets and liabilities measured at fair value, the level within the fair value hierarchy used, information about any level 3 measurements, and the valuation technique used.
- b. The category for recurring measurements requires additional disclosure of unrealized gains and losses arising from changes in fair value.
- c. The category for nonrecurring measurements requires additional disclosure of the reasons for the measurements.

The Effect of the Fair Value Measurement Guidance on Financial Statements Prepared Using an Other Comprehensive Basis of Accounting. The measurement guidance will have no effect on financial statements prepared on the pure cash basis because the only asset recognized under that basis is cash and no liabilities are recognized.

The measurement guidance in SFAS No. 157 (FASB ASC 820) will have no effect on amounts reported in the face of financial statements prepared using the income tax basis of accounting because any fair value measurements should be determined following the requirements for income tax reporting. However, the measurement guidance may affect—

- a. supplemental disclosure of the fair value of financial instruments.
- b. the description of differences between the income tax basis and generally accepted accounting principles in the highly unlikely event that an asset or liability is required to be reported at fair value under both generally accepted accounting principles and the income tax basis, but as a result of SFAS No. 157 (FASB ASC 820), the way fair value is determined is different for income tax reporting.

If an entity modifies the pure cash basis of accounting to recognize an asset or a liability that generally accepted accounting principles require to be measured at fair value, the modification should be in conformity with the measurement guidance of SFAS No. 157 (FASB ASC 825-10) after its effective date. As a practical matter, however, modifications of the cash basis to conform with generally accepted accounting principles that require fair value measurements are likely to only be for debt and equity securities within the scope of SFAS No. 115 or SFAS No. 124 (FASB ASC 958), which generally prescribe level 1 measurements.

The Effect of the Fair Value Disclosure Guidance on Financial Statements Prepared Using an Other Comprehensive Basis of Accounting. As a practical matter, depending on the facts and circumstances, the characteristics of those assets and liabilities are likely to be such that the determination of their fair values falls within level 1.

As an illustration, assume that—

- a. modified cash basis financial statements of an LLC treated as a partnership for income tax reporting include equity securities measured at fair value based on quoted market prices in an active market, which is a level 1 measurement;
- b. unrealized appreciation in the fair value of those securities increased by \$15,000 during the year, from \$45,000 to \$60,000;

- c. there were no purchases or sales of securities during the year; and
- d. the entity believes it can communicate the substance of the SFAS No. 115 (FASB ASC 320-10) and SFAS No. 130 (FASB ASC 220-10-45-3) presentation requirements for other comprehensive income through disclosure of the beginning and ending amounts of unrealized appreciation and the change during the year in those amounts.

The following illustrates appropriate disclosure following the requirements of SFAS No. 115 (FASB ASC 320-10) and the requirements of SFAS No. 157 (FASB ASC 820-10) for recurring fair value measurements.

The entity's investment in equity securities is reported at their fair value determined using quoted market prices in active markets. The unrealized appreciation in the fair value of those securities increased \$15,000 during the year, from \$45,000 to \$60,000. Dividends of \$2,000 were received during the year. There were no purchases or sales.

A The Fair Value Option. SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. The (FASB ASC 825-10) permits entities to choose to measure prescribed financial instruments at fair value. Generally, the fair value option is permitted for all financial assets and financial liabilities other than financial assets and financial liabilities that are specifically excluded.

Generally, a financial asset is defined as a financial instrument that conveys a right to the entity, and a financial liability is defined as a contract that imposes an obligation on the entity. For example, an entity could elect the fair value option for an investment that would otherwise be accounted for using the cost of equity method. Similarly, an entity could elect the fair value option for a fixed-rate long-term note.

The disclosure requirements of SFAS No. 159 (FASB ASC 825-10) only apply if an entity has elected the fair value option. Those requirements generally look at how the election affects the measurement of those assets and liabilities. For example, disclosure is required of the reason for electing the fair value option and information about differences between the fair values and contractual cash flows. In addition, the measurement and disclosure requirements of SFAS No. 157 (FASB ASC 820) apply to those assets and liabilities.

The Effect of the Fair Value Option on Financial Statements Prepared Using an Other Comprehensive Basis of Accounting. In pure cash basis financial statements, cash is the only asset recorded, and no liabilities are recorded. Although cash is a financial asset, its face amount and fair value are the same. Therefore, SFAS No. 159 (FASB ASC 825-10) cannot affect financial statements prepared on the pure cash basis of accounting.

The guidance also cannot affect financial statements prepared on the income tax basis. Whether assets and liabilities are measured at fair value in those financial statements depends on the requirements for income tax reporting.

The guidance in SFAS No. 159 (FASB ASC 825-10) is provided with the perspective that the financial statements are prepared using generally accepted accounting principles.

Presenting Consolidated or Combined Financial Statements

ARB No. 51, *Consolidated Financial Statements* (FASB ASC 810-10-25-1), requires the reporting entity to include in its financial statements the consolidated financial results of any entity in which it has a controlling financial interest. While ownership of a majority voting equity interest is the most common way for the reporting entity to have a controlling financial interest in another entity, ARB No. 51 (FASB ASC 810-10-15-8) acknowledges that there are other ways. The reporting entity also has the option of including in its financial statements the combined financial results of a commonly controlled entity. Consolidation and combination generally produce the same results except that the components of equity differ.

In consolidated financial statements, net assets are effectively allocated between two groups of equity investors—the controlling financial interest and the noncontrolling financial interest.

- a. The amount allocated to the controlling financial interest generally is the amount of net assets the reporting entity would recognize in financial statements presented using the equity method. That amount represents

the net assets of the reporting entity, including its share of the net assets of the other entities whose financial results are included in the financial statements.

- b. The amount allocated to the noncontrolling financial interest is the share of the other equity investors in the net assets of the other entities whose financial results are included in the financial statements.

To illustrate, assume that the reporting entity has a 70% equity interest in another entity. The equity investors of the reporting entity effectively hold all of its net assets, including its share of the net assets of the other entity. This is considered to be the controlling financial interest in consolidated net assets. The only portion of consolidated net assets that the equity investors of the reporting entity do not hold is the 30% equity interest in the other entity that is held by other investors. This is considered to be the noncontrolling financial interest in consolidated net assets.

In combined financial statements, the equity of each of the combined entities remains intact. The distinction between controlling and noncontrolling financial interests is not relevant. Instead of the reporting entity having a controlling financial interest in other entities whose consolidated financial results are included in the financial statements, another investor has a controlling financial interest in each of the entities whose financial results are included in the financial statements.

Considering Consolidation and Combination in Preparing Pure Cash and Modified Cash Basis Financial Statements. A controlling financial interest in another entity would be recognized in pure cash basis financial statements only if the reporting entity had paid for the interest. The payment would be recognized as a disbursement. The notion of treating the acquisition of a controlling financial interest as a disbursement is inconsistent with the consolidation requirements of ARB No. 51 (FASB ASC 810-10).

The reporting entity could elect to modify the pure cash basis to recognize as an investment payments to acquire a controlling financial interest. It could further elect to modify the pure cash basis to recognize as an investment an obligation to acquire a controlling financial interest. Would those elections require the reporting entity to consolidate the financial results of the entity in which it has a controlling financial interest?

The answer depends on whether consolidation is viewed as a measurement principle or a presentation issue, and accountants differ as to which view is preferable.

- a. *Measurement.* If consolidation is viewed as a measurement principle, the reporting entity should include the consolidated financial results of the controlling financial interests recognized in its modified cash basis financial statements.
- b. *Presentation.* If consolidation is viewed as a presentation issue, the reporting entity should either follow those same consolidation requirements or communicate their substance in some other manner. For example, information about the assets, liabilities, equity, and net income of the entity in which the reporting entity has a controlling financial interest could be communicated through a note to the financial statements.

Generally, if consolidated financial statements are prepared for entities using the modified cash basis—

- a. The financial results of all entities in which the reporting entity has a controlling financial interest should be consolidated.
- b. The financial results of all consolidated entities should be presented on the modified cash basis of accounting using substantially the same modifications of the pure cash basis.
- c. All balances and transactions between the entities whose financial results are included in the consolidated financial statements should be eliminated.
- d. Any noncontrolling interests should be recognized.
- e. The consolidation policy should be disclosed.

Generally accepted accounting principles encourage the presentation of combined financial statements when entities with similar operations are commonly controlled.

Considering Consolidation and Combination in Preparing Income Tax Basis Financial Statements. The requirement of in GAAP to present consolidated financial statements does not apply to income tax basis financial statements. Generally, only C corporations can be included in a consolidated income tax return, and 80% ownership is required. As an observation, if an entity is treated as a disregarded entity for income tax reporting, such as when the reporting entity is the sole member of a limited liability company or the sole stockholder of a qualified subchapter S subsidiary, a consolidated income tax return is not filed. Instead, the other entity is treated as if it were in substance liquidated into the reporting entity. The reporting entity files the normal return, includes the financial results of the other entity, and does not mention its existence.

Basis of Consolidation. Entities preparing cash basis financial statements may choose to modify those statements by consolidating majority-owned subsidiaries. If consolidated financial statements are presented, APB Opinion No. 22 (FASB ASC 235-10-50-1; 235-10-50-2; 235-10-50-3; 235-10-50-4; 235-10-50-5; 235-10-50-6; 235-10-5-3; 235-10-5-4) requires the basis of consolidation to be disclosed in GAAP financial statements. Consolidated cash basis financial statements generally should also include that disclosure. The following is an example disclosure:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The accompanying consolidated financial statements include Electrical Engineers, Inc. and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

Combined returns are not permitted for income tax purposes. Therefore, combined tax basis financial statements should not be presented.

Acquiring a Controlling Financial Interest

ARB No. 51 (FASB ASC 810-10-25-1) requires the reporting entity to include in its financial statements the consolidated financial results of all entities in which it has a controlling financial interest. SFAS No. 141, *Business Combinations*, provides guidance on the initial consolidation when the reporting entity acquires a controlling financial interest. Generally, SFAS No. 141 carried forward the related requirements of the prior authoritative guidance in APB Opinion No. 16, also titled *Business Combinations*, and requires recording amounts in the initial consolidation based on allocations of the purchase price.

A revised version of SFAS No. 141, often referred to as *SFAS No. 141(R)*, was issued in December 2007. SFAS No. 141(R) (FASB ASC 805) takes a different approach to recording amounts in the initial consolidation, generally basing them on fair values. SFAS No. 141(R) (FASB ASC 805) is first effective for years beginning on or after December 15, 2008. Early adoption is not permitted. Therefore it is generally first effective for calendar years ending December 31, 2009.

The measurement requirements of SFAS No. 141 would not be applicable to financial statements prepared on the pure cash basis of accounting. Instead, the acquisition of a controlling financial interest is only reported if a payment is made, and all payments would be recognized as disbursements. The measurement requirements of SFAS No. 141 are not applicable to income tax basis financial statements, since acquisitions are accounted for in those financial statements based on tax positions taken.

In addition to measurement guidance, SFAS No. 141 also provides disclosure guidance. Some of the required disclosures are relevant only to measurements following the requirements of SFAS No. 141, but others provide more general information such as a description of the transaction.

Noncontrolling Financial Interests

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements*, (FASB ASC 810-10). Compliance is required for years beginning after December 15, 2008. Early adoption is not allowed. Among other things, a noncontrolling financial interest is required to be presented as a component of consolidated equity.

Previously, the authoritative accounting literature did not address how to present a noncontrolling financial interest in consolidated financial statements. Historically, the dominant practice has been to present the controlling financial interest as equity and the noncontrolling financial interest between liabilities and equity. This presentation is often referred to as a mezzanine presentation because the basic accounting equation is assets = liabilities + equity, and under this method, the noncontrolling financial interest is presented between liabilities and equity.

FASB Statement of Financial Accounting Concepts (SFAC) No. 6, *Elements of Financial Statements*, expressed a preference for presenting minority interests as a part of equity, rather than a liability. This is consistent with the basic accounting equation. In addition, the requirement in SFAS No. 160 (FASB ASC 810-10) that the noncontrolling financial interest should be presented as a component of equity is the same as the position the FASB took in the June 2005 exposure draft of a proposed SFAS, *Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries*.

The absence of guidance in the authoritative accounting literature, the preference expressed in SFAC No. 6, and the FASB's continuing position provide evidence that presentation of the noncontrolling interest as a component of equity is an appropriate approach even before SFAS No. 160 (FASB ASC 810-10) becomes effective.

As an observation, the authoritative accounting literature does not prescribe a method for allocating consolidated earnings to the controlling and noncontrolling financial interests. Instead, ARB No. 51 (FASB ASC 810-10-45-6) says, only that the "elimination of the intra-entity profit or loss may be allocated proportionately between the majority and minority interests." FIN 46, *Consolidation of Variable Interest Entities*, prescribes a method of allocating eliminations in consolidations within its scope that generally results in assigning to the controlling and noncontrolling financial interests the same earnings they would report in stand-alone financial statements.

However, SFAS No. 160 (FASB ASC 810-10) does not prescribe an allocation method for consolidations in general. Instead, it only modifies ARB No. 51 to say the "elimination of intercompany income or loss may be allocated" between the two interests.

Measurement Considerations. In consolidated income tax basis financial statements, the allocation of consolidated earnings and net assets to the controlling and noncontrolling financial interests should be the same as the allocation method used in the reporting entity's consolidated income tax return. As a practical matter, in consolidated pure cash basis financial statements, equity would consist only of cash; allocating a single asset between controlling and noncontrolling financial interests does not provide useful information. However, earnings and net assets reported in consolidated financial statements prepared on the modified cash basis of accounting should be allocated between controlling and noncontrolling financial interests.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

16. SFAS No. 157 looks at how fair value should be determined when existing generally accepted accounting principles require fair value measurement. The guidance accomplishes that by providing a fair value hierarchy consisting of three levels—levels 1, 2, and 3. These levels generally range from the most objective determination of fair value to the most subjective. Which of the following is considered the most subjective?
 - a. Measurements based on the entity's own assumptions.
 - b. Measurements that use indirect available information.
 - c. Measurements that use quoted prices in active markets for identical assets that the reporting entity can access at the measurement date.
17. In consolidated financial statements, net assets are effectively allocated between the controlling financial interest and the noncontrolling financial interest. The amount allocated to the noncontrolling financial interest consists of which of the following?
 - a. The amount of net assets the reporting entity would recognize in financial statements presented using the equity method.
 - b. The share of the other equity investors in the net assets of the other entities whose financial results are included in the financial statements.
18. What should a reporting entity do when a consolidation is viewed as a presentation issue?
 - a. The reporting entity should include the consolidated financial results of the controlling financial interests recognized in its modified cash basis financial statements.
 - b. The reporting entity should communicate their substance in some other manner.
19. Which of the following statements regarding what can happen if consolidated financial statements are prepared using the modified cash basis is considered a best practice?
 - a. All balances and transactions between the entities whose financial results are included in the consolidated financial statements should be included.
 - b. The consolidation policy should be disclosed.
 - c. The financial results of all consolidated entities should be presented on the modified cash basis of accounting using substantially the same modifications of the modified basis.
20. Which of the following statements regarding measurement considerations is most accurate?
 - a. In consolidated income tax basis financial statements, the allocation of consolidated earnings and net assets to the controlling and noncontrolling financial interests should be different from the allocation method used in the reporting entity's consolidated income tax return.
 - b. Equity consists of only cash in consolidated pure cash basis financial statements.
 - c. Generally, earnings and net assets reported in consolidated financial statements prepared on the pure cash basis of accounting should be allocated between controlling and noncontrolling financial interests.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

16. SFAS No. 157 looks at how fair value should be determined when existing generally accepted accounting principles require fair value measurement. The guidance accomplishes that by providing a fair value hierarchy consisting of three levels—levels 1, 2, and 3. These levels generally range from the most objective determination of fair value to the most subjective. Which of the following is considered the most subjective? **(Page 44)**
- a. **Measurements based on the entity's own assumptions. [This answer is correct. Level 3 measurements are the most subjective, generally based on the entity's own assumptions developed using the best information available in the circumstances.]**
 - b. Measurements that use indirect available information. [This answer is incorrect. Level 2 measurements generally use available indirect information, such as quoted prices for similar assets or liabilities in active markets, or quoted prices for identical or similar assets or liabilities in markets that are not active.]
 - c. Measurements that use quoted prices in active markets for identical assets that the reporting entity can access at the measurement date. [This answer is incorrect. Level 1 measurements use quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.]
17. In consolidated financial statements, net assets are effectively allocated between the controlling financial interest and the noncontrolling financial interest. The amount allocated to the noncontrolling financial interest consists of which of the following? **(Page 46)**
- a. The amount of net assets the reporting entity would recognize in financial statements presented using the equity method. [This answer is incorrect. The amount allocated to the controlling financial interest generally is the amount of net assets the reporting entity would recognize in financial statements presented using the equity method. That amount represents the net assets of the reporting entity, including its share of the net assets of the other entities whose financial results are included in the financial statements.]
 - b. **The share of the other equity investors in the net assets of the other entities whose financial results are included in the financial statements. [This answer is correct. The amount allocated to the noncontrolling financial interest is the share of the other equity investors in the net assets of the other entities whose financial results are included in the financial statements. For example, assume that the reporting entity has a 70% equity interest in another entity. The equity investors of the reporting entity effectively hold all of its net assets, including its share of the net assets of the other entity. This is considered to be the controlling financial interest in consolidated net assets. The only portion of consolidated net assets that the equity investors of the reporting entity do not hold is the 30% equity interest in the other entity that is held by other investors. This is considered to be the noncontrolling financial interest in consolidated net assets.]**
18. What should a reporting entity do when a consolidation is viewed as a presentation issue? **(Page 47)**
- a. The reporting entity should include the consolidated financial results of the controlling financial interests recognized in its modified cash basis financial statements. [This answer is incorrect. If consolidation is viewed as a measurement principle, the reporting entity should include the consolidated financial results of the controlling financial interests recognized in its modified cash basis financial statements.]
 - b. **The reporting entity should communicate their substance in some other manner. [This answer is correct. When consolidation is viewed as a presentation issue, the reporting entity should communicate their substance in some other manner. For example, information about the assets, liabilities, equity, and net income of the entity in which the reporting entity has a controlling financial interest could be communicated through a note to the financial statements.]**

19. Which of the following statements regarding what can happen if consolidated financial statements are prepared using the modified cash basis is considered a best practice? **(Page 47)**

- a. All balances and transactions between the entities whose financial results are included in the consolidated financial statements should be included. [This answer is incorrect. All balances and transactions between the entities whose financial results are included in the consolidated financial statements should be eliminated.]
- b. The consolidation policy should be disclosed. [This answer is correct. The consolidation policy should be disclosed. The following is an example disclosure:**

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The accompanying consolidated financial statements include Electrical Engineers, Inc. and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.]

- c. The financial results of all consolidated entities should be presented on the modified cash basis of accounting using substantially the same modifications of the modified basis. [This answer is incorrect. The financial results of all consolidated entities should be presented on the modified cash basis of accounting using substantially the same modifications of the pure cash basis.]

20. Which of the following statements regarding measurement considerations is most accurate? **(Page 49)**

- a. In consolidated income tax basis financial statements, the allocation of consolidated earnings and net assets to the controlling and noncontrolling financial interests should be different from the allocation method used in the reporting entity's consolidated income tax return. [This answer is incorrect. In consolidated income tax basis financial statements, the allocation of consolidated earnings and net assets to the controlling and noncontrolling financial interests should be the same as the allocation method used in the reporting entity's consolidated income tax return.]
- b. Equity consists of only cash in consolidated pure cash basis financial statements. [This answer is correct. In consolidated pure cash basis financial statements, equity would consist only of cash; allocating a single asset between controlling and noncontrolling financial interests does not provide useful information.]**
- c. Generally, earnings and net assets reported in consolidated financial statements prepared on the pure cash basis of accounting should be allocated between controlling and noncontrolling financial interests. [This answer is incorrect. Earnings and net assets reported in consolidated financial statements prepared on the modified cash basis of accounting should be allocated between controlling and noncontrolling financial interests.]

EXAMINATION FOR CPE CREDIT**Lesson 1 (OFSTG091)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Which of the following is required for OCBOA financial statements under the revised Interpretation 14 of SAS No. 62?
 - a. The discussion of basis of presentation must quantify how that basis of accounting differs from GAAP.
 - b. If provided amounts require disclosure under GAAP, the disclosure must be made or the information otherwise conveyed.
 - c. GAAP requirements for the presentation of the financial statements are not required under the OCBOA basis.
 - d. A statement of cash flows is required to be included in the income tax basis financial statements.

2. Match the following pieces of authoritative literature with the relevant guidance.

1. SSARS No. 15	i. Requires voluntary health and welfare organizations to issue a separate financial statement in a matrix format showing expenses according to their functional and natural classifications.
2. SFAS No. 144	ii. Requires income statements to show the results of discontinued operations of a component of an entity net-of-tax as a separate component of income.
3. SFAS No. 117	iii. Requires all nonprofit organizations to classify net assets on the statement of financial position as permanently restricted, temporarily restricted, and unrestricted, and to use those categories in the statement of activities. iv. Amends SSARS No. 1 by eliminating certain references to auditing literature and, where deemed appropriate, incorporating guidance similar to the guidance that was originally referenced.

 - a. 1. iv.; 2., ii.; 3., i. and iii.
 - b. 1. i.; 2., ii. and iii.; 3., iv.
 - c. 1. i. and iii.; 2., iv.; 3., ii.
 - d. 1. iii.; 2., i. and ii.; 3., iv.

3. Abernathy-Petersmith is required to present a full set of basic income tax basis financial statements to its stockholders, but it only needs to present a statement of assets, liabilities, and equity to its financial institution. How will the presentation of the statements be affected?
 - a. The statement of assets, liabilities, and equity can be pulled from the set of full statements and presented without any disclosures.
 - b. A new set of notes to the statement of assets, liabilities, and equity must be prepared for a relevant presentation.
 - c. The statement of assets, liabilities, and equity can be pulled from the set of full statements and presented with the full set of disclosures.

- d. Presentation of one statement separate from the full set is not allowed as it would not be a relevant presentation.
4. Michael & Blythe present its financial statements using the income tax basis of accounting. The resulting presentation has **no** material differences from the presentation Michael & Blythe would have if the company used GAAP. How would the statements be affected?
- a. The statements do not need to disclose the basis of accounting used because there were no material differences.
 - b. The statements should disclose whether the cash or accrual basis of accounting was used.
 - c. The statements must be reported on as being prepared by GAAP because there were no material differences.
 - d. The statements must disclose the differences between the income tax basis and GAAP.
5. GAAP requires a variety of disclosures for items reported in the financial statements. Which scenario illustrates an instance when the GAAP disclosure is relevant to income tax basis financial statements?
- a. Belo Industries has depreciable assets and discloses depreciation expense.
 - b. Cora's Clocks discloses deferred taxes (a component of income taxes).
 - c. Fiona's Fine Furniture recognizes losses when they are realized and reports information about asset valuation allowances.
 - d. Raise Awareness is a nonpublic entity with total assets of \$50 million and discloses information about the fair value of financial instruments.
6. The Lyndon Company recognizes trade receivables in its tax basis financial statements. The company communicates the substance of the disclosure requirements of SOP 01-6 as follows: Trade receivables are reported at the amount of principal outstanding. Balances are written off through charges to earnings only after management has exhausted reasonable collection efforts and concluded that additional collection efforts are not cost effective. What method of disclosure did the company use?
- a. Expansion of the line item in the financial statements.
 - b. A debt disclosure combined with presentation of the carrying amount of trade receivables.
 - c. A separate policy note.
 - d. The basis of accounting note.
7. SOP 94-6 provides a variety of disclosure considerations in four key areas. If a company's estimated direct costs are used to calculate the percentage of completion of contracts, a disclosure in which of the SOP's key areas is relevant to the company's tax basis financial statements?
- a. Nature of operations.
 - b. General use of estimates.
 - c. Certain significant estimates.
 - d. Significant concentrations of risk.
8. Which of the following statements concerning omission of substantially all disclosures on financial statements prepared using a comprehensive basis of accounting other than generally accepted accounting principles is correct?

- a. Each omitted disclosure of which the accountant is aware must be addressed in the compilation report on financial statements.
 - b. Disclosing the use of the income tax basis in the accountant's compilation report is not necessary when compiling financial statements.
 - c. Accountants reporting on compiled financial statements which omit substantially all disclosures do not have to individually address each of those omitted disclosures.
 - d. Management is prohibited by SSARS No. 1 from providing additional disclosures.
9. Match the following definition with the appropriate term.
- A contractual, ownership, or other pecuniary interest whose fair value changes with changes in the fair value of the entity's net assets.
- a. Variable interest.
 - b. Variable interest entity.
 - c. Reporting entity.
 - d. Primary beneficiary.
10. Drier's presents income tax basis financial statements. If Drier's meets the qualifications for consolidation under the authoritative literature on accounting for a variable interest in a variable interest entity, how will its financial statements be affected?
- a. Consolidated statements are only allowed if Drier's presented consolidated income tax returns.
 - b. Drier's is prohibited from consolidating financial statements because it does not use GAAP.
 - c. The company must follow the consolidation guidance in the authoritative literature on accounting for a variable interest in a variable interest entity if it applies.
 - d. Do not select this answer choice.
11. Snow Brothers presents its financial statements on the income tax basis. Snow Brothers is the reporting entity for Greene Sisters. Snow Brothers files consolidated income tax returns. Can Snow Brothers file parent-company financial statements?
- a. It can always file parent-company financial statements.
 - b. It cannot file parent-company statements because of the consolidated income tax returns.
 - c. It is prohibited by ARB No. 51 from filing parent-company financial statements.
 - d. It must file both parent-company and consolidated financial statements.
12. Thompson & Thomson is a small nonpublic entity that presents its financial statements on the income tax basis. There is a risk in the company's position on the deduction of certain expenses, and the company believes that, if the IRS were to examine the return, the probability of an unfavorable outcome is high. The difference in the amounts would be material. Apply the guidance in FIN 48 and determine how the company should proceed.
- a. No action is required unless the IRS actually does examine the tax return and disallows the deduction.
 - b. The company can choose to disclose the difference if it would keep the statements from being misleading.

- c. The company must disclose the difference and submit an amended income tax return.
 - d. The company must disclose the difference after the description of other significant differences.
13. Which of the following FIN 48 disclosures is relevant to income tax basis financial statements?
- a. Disclosure of the tax years that remain subject to examination by major tax jurisdictions.
 - b. Disclosure of the entity's policy for presenting interest and penalties related to income taxes.
 - c. Disclosures about unrecognized tax benefits.
 - d. Do not select this answer choice.
14. Washington & Roosevelt presents its financial statements using the pure cash basis modified to recognize investments in debt and equity securities and any unrealized appreciation and depreciation in their fair value and to recognize income tax assets and liabilities. Washington & Roosevelt believe the primary users of the financial statements are mainly interested in cash flow consequences and that the financial statements should clearly communicate that realizing changes in the fair value of the securities would have tax implications that would alter cash flows. Using the facts and circumstances above, what would Washington & Roosevelt conclude in regards to recognizing current and deferred income tax assets and liabilities?
- a. That recognizing both current and deferred income tax assets and liabilities is important to the primary users of the financial statements.
 - b. That only recognizing liabilities and current income tax assets are sufficient for its reporting purposes.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.
15. Match the following pieces of authoritative literature with the relevant guidance.
- | | |
|------------------|---|
| 1. SSARS No. 107 | i. Requires disclosure of the fair value of financial instruments unless the entity is a nonpublic entity, its assets are less than \$100 million, and it has no derivatives |
| 2. SFAS No. 115 | ii. Requires a nonrecurring adjustment of the carrying amount of intangible assets to their fair value to recognize an impairment loss |
| 3. SFAS No. 142 | iii. Requires investments in equity securities that are available for sale and for which fair value is readily determinable to be measured at their fair value on a recurring basis |
- a. 1, i; 2, ii; 3, iii.
 - b. 1, ii; 2, i; 3, ii.
 - c. 1, iii; 2, ii; 3, i.
 - d. 1, i; 2, iii; 3, ii.
16. The measurement guidance in SFAS No. 157 on financial statements prepared using OCBOA does **not** affect which of the following?
- a. Supplemental disclosure of the fair value of financial instruments.

- b. Financial statements prepared on the pure cash basis.
 - c. The description of differences between the income tax basis and GAAP.
 - d. Do not select this answer choice.
17. If Bells, Inc. modifies the pure cash basis of accounting to recognize an asset or a liability that generally accepted accounting principles requires to be measured at fair value, the modification should be in conformity with the measurement guidance of _____ after its effective date.
- a. SFAS No. 115.
 - b. SFAS No. 124.
 - c. SFAS No. 156.
 - d. SFAS No. 157.
18. SFAS No. 159 permits entities to do which of the following?
- a. Measure prescribed financial instruments at fair value.
 - b. Include consolidated financial results of any entity in which it has a controlling financial interest in its financial statements.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.
19. The requirement of ARB No. 51 to present consolidated financial statements does not apply to income tax basis financial statements. Generally, only C corporations can be included in a consolidated income tax return. What percent ownership is required?
- a. 50%.
 - b. 65%.
 - c. 80%.
 - d. 100%.
20. The guidance in the fair value option **cannot** affect financial statements prepared on which of the following?
- a. Modified cash basis of accounting.
 - b. Generally accepted accounting principles.
 - c. Pure cash basis of accounting.
 - d. Do not select this answer choice.

Lesson 2: Reporting on OCBOA Financial Statements

INTRODUCTION

Practitioners have the same reporting alternatives for OCBOA financial statements as they do for GAAP basis financial statements. That is, depending on the level of service they provide, they issue compilation, review, or audit reports on the financial statements. The following sections discuss issues that should be considered when preparing compilation, review, or audit reports on OCBOA financial statements. For further guidance on reporting on compilations or reviews, refer to *PPC's Guide to Compilation and Review Engagements*. For additional guidance on reporting on audit engagements, refer to *PPC's Guide to Auditor's Reports*.

Learning Objectives:

Completion of this lesson will enable you to:

- Utilize the general reporting considerations for income tax basis financial statements and determine how compilation and review reports are affected by use of the income tax basis.
- Determine how auditor's reports are affected by use of the income tax basis.
- Identify other reporting situations that should be considered when reporting on OCBOA financial statements.

General Reporting Considerations

Report Title. No heading or title is needed when the accountants' compilation or review report appears on letterhead, although some accountants prefer to use a title to avoid any misunderstanding about the type of report. When the report does not appear on letterhead, best practices indicate that accountants should use a heading such as "ACCOUNTANTS' REPORT" or "ACCOUNTANTS' REPORT ON FINANCIAL STATEMENTS."

SAS No. 58 (AU 508) requires the auditors' report to be titled and include the word "independent." Generally, accountants should use "INDEPENDENT AUDITORS' REPORT" as the title of audit reports.

Addressing the Report. The report on a corporation's (either a C or S corporation's) financial statements generally should be addressed to the company whose financial statements are being presented or to its board of directors or stockholders. The terms "shareholders" or "shareowners" may be substituted for "stockholders." (Preferably, the term should be consistent with the company's articles of incorporation.) The report on a proprietorship's financial statements generally is addressed to the proprietor. The report on a partnership's financial statements generally is addressed to the partnership using the name authorized in the partnership agreement or to the partners (or to the managing or general partner). Likewise, the report on a limited liability company's financial statements generally is addressed to the members or the Board of Members. The report on a nonprofit organization's financial statements is usually addressed to the governing board (for example, the board of directors or trustees). The report could be addressed to the organization itself if the client so desires.

The city and state (but not the street address or post office box number) in which the entity is located also are commonly included in the report address. However, many firms omit the city and state, especially when the report is addressed to stockholders who are widely dispersed.

Financial Statement Titles. SAS No. 62 and SSARS No. 1 (AR 100.04), indicate that OCBOA financial statements should be titled using terms that do not imply financial presentation in conformity with GAAP. Financial statement titles used in the compilation, review, or audit report should reflect the titles used within the body of the financial statements. For example, a report on tax basis financial statements might refer to the "statement of assets, liabilities, and equity—income tax basis" while a report on cash basis financial statements might refer to the "statement of cash receipts and disbursements."

The order in which the financial statements are referred to in the report need not follow any prescribed pattern or even the order in which the financial statements are physically arranged.

Firm's Signature. SSARS No. 1 (AR 100.13), requires that the accountants' report contain the signature of the accounting firm or the accountant, as appropriate. It also clarifies that the signature may be manual, stamped,

electronic, or typed. SAS No. 58, *Reports on Audited Financial Statements*, requires the auditor's standard report to include the manual or printed signature of the auditor's firm.

The firm's signature normally is signed manually when the report is typed on the firm's letterhead. When the report is printed on plain paper or included in a client-prepared annual report, some firms print "Certified Public Accountants" below the firm's signature. (Use of the CPA designation may be restricted by state regulations.) Some firms, especially multilocation firms, identify the city and state of the office that issued the report below the signature.

Report Date. SSARS No. 1 states that the report date should be the date substantially all procedures were completed. For compilations, best practices indicate that generally occurs on the date the financial statements are "read," as the term is used in SSARS No. 1 (AR 100.11). The date of completion of the accountant's review procedures should be used as the date of his or her report on reviewed financial statements.

The date of the auditor's report should not be earlier than the date when the auditor has obtained sufficient appropriate audit evidence to support the opinion (AU 530.01).

COMPILATION AND REVIEW REPORTS

The Standard Reports

In a compilation, accountants do not express any assurance on the financial statements. (Accountants must, at a minimum, compile financial statements that they submit to clients or others.) The accountants' report states that—

- a. the financial statements were compiled in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
- b. a compilation is limited to presenting in the form of financial statements information that is the representation of management (owners).
- c. the financial statements have not been audited or reviewed and, accordingly, the accountant does not express an opinion or any other form of assurance on them.

The report does not refer to any other procedures that the accountants may have performed. To do so might lead the reader of the financial statements to conclude that the accountants are, in fact, offering some form of assurance.

Unlike a compilation, a review engagement is designed to provide limited assurance on the financial statements. In a review of financial statements, accountants perform inquiry and analytical procedures to reasonably determine that no material modifications should be made to the statements for them to be in conformity with the OCBOA. The review report states that—

- a. the accountants reviewed the financial statements in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
- b. all information included in the financial statements is the representation of the management (owners) of the entity.
- c. a review consists principally of inquiries of company personnel and analytical procedures applied to financial data.
- d. a review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements taken as a whole and, accordingly, no such opinion is expressed.
- e. the accountants are not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with the OCBOA other than those modifications, if any, indicated in the report.

The report does not describe any other procedures the accountants may have performed before or during the review engagement, including those performed in connection with a compilation of the financial statements.

Exhibit 2-1 and Exhibit 2-2 illustrate reports for a compilation and a review assuming the financial statements were prepared on the income tax basis of accounting.

Exhibit 2-1

Standard Compilation Report—Income Tax Basis of Accounting

To the Board of Directors

XYZ Company
City, State

I (We) have compiled the accompanying statement of assets, liabilities, and equity-income tax basis of XYZ Company as of December 31, 20X8, and the related statement of revenues, expenses, and retained earnings-income tax basis for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management (the owners). I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

Firm's signature

February 15, 20X9

* * *

Exhibit 2-2

Standard Review Report—Income Tax Basis of Accounting

To the Board of Directors

XYZ Company
City, State

I (We) have reviewed the accompanying statement of assets, liabilities, and equity-income tax basis of XYZ Company as of December 31, 20X8, and the related statement of revenues, expenses, and retained earnings-income tax basis for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

A review consists principally of inquiries of Company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with the income tax basis of accounting, as described in Note A.

Firm's signature

February 15, 20X9

* * *

Management-use-only Financial Statements. SSARS No. 1, allows accountants to provide clients with management-use-only financial statements without issuing a compilation report if the statements are not reasonably expected to be used by third parties. In lieu of a compilation report, the accountant is required to (a) make specific written communications to management in an engagement letter, preferably signed by management, and (b) include on each page of the management-use-only financial statements a reference such as "Restricted for Management's Use Only."

Reference to Country of Origin. SAS No. 93, *Omnibus Statement on Auditing Standards—2000*, modified the basic elements of the auditor's standard report on GAAP financial statements to include an identification of the United States of America as the country of origin of (1) the accounting principles used to prepare the financial statements and (2) the auditing standards followed in performing the audit. Some accountants have questioned whether the country of origin language described by SAS No. 93 should be incorporated in a compilation or review report for nonissuers. The Accounting and Review Services Committee issued Interpretation 24 of SSARS No. 1, *Reference to the Country of Origin in a Review or Compilation Report*, to address this question. The Interpretation states that SSARS do not require the reference to the country of origin of the accounting principles used to prepare the financial statements since compilation and reports issued under SSARS refer to the American Institute of Certified Public Accountants. The interpretation also states that nothing in SSARS No. 1 precludes accountants from including such language in their compilation and review reports if they believe such a reference is appropriate under the circumstances.

Interpretation No. 24, *Reference to the Country of Origin in a Review or Compilation Report*, was revised to include illustrative report language. In the case of a compilation, if an accountant wishes to reference the country of origin, an emphasis of matter paragraph should be added to the compilation report. For a review, the third paragraph of the standard review report should be modified to include a reference to the country of origin.

Modifications to Compilation and Review Reports

The reports presented in Exhibit 2-1 and Exhibit 2-2 should be modified when the financial statements contain departures from the OCBOA or, in the case of compilation reports, when the accountants are not independent. The following paragraphs discuss common issues that may require modifications to reports on compiled or reviewed OCBOA financial statements.

Lack of Independence. While accountants are precluded from issuing audit or review reports when they are not independent, they may issue compilation reports provided they comply with the compilation standards. In such cases, the compilation report should specifically disclose the lack of independence by including the following as the last paragraph:

We are not independent with respect to XYZ Company.

Paragraph 23 of SSARS No. 1 (AR 100.23) prohibits describing the reason for the lack of independence.

Substantially All Disclosures Omitted. Compiled financial statements may omit substantially all disclosures provided the compilation report discloses the omission and the omission is not, to the accountants' knowledge, undertaken to mislead those who might reasonably be expected to use the financial statements. In such cases, a third paragraph should be added to the compilation report to point out the omission and that the omitted disclosures might influence the user's conclusions about the financial statements. An example follows:

Management has (The owners have) elected to omit substantially all of the disclosures ordinarily included in financial statements prepared on the cash (or income 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, revenues, and expenses. Accordingly, these financial statements are not designed for those who are not informed about such matters.

In addition, the use of an other comprehensive basis of accounting should be disclosed in the first paragraph of the compilation report if it is not disclosed in the financial statements.

The guidance at AR 100.54–.55 states that an accountant's compilation or review report may include a paragraph that emphasizes something the accountant believes is important. However, that guidance also clarifies that the paragraph can only emphasize information disclosed in the financial statements. Therefore, an emphasis paragraph cannot be added to a compilation report on financial statements that omit substantially all disclosures in lieu of an omitted disclosure.

To illustrate, assume that an accountant is reporting on financial statements of an LLC and management has elected to omit substantially all disclosures. The financial statements are prepared using the income tax basis of accounting. Because of the facts and circumstances, the accountant believes it is important to emphasize that the entity does not incur income taxes. Because of the laws of the state in which the entity was formed, the entity's name includes the designation *LLC*. It should be obvious to any knowledgeable reader that an LLC does not incur income taxes and therefore the name used in the headings of the financial statements provides sufficient disclosure that the entity is tax-exempt. Therefore, the accountant could add a paragraph such as the following to the compilation report.

Since the entity is a limited liability company, it does not incur income taxes and instead the taxable income of the entity is included in the personal taxable income of the individual members and taxed accordingly.

But what if the entity is an S corporation? In that situation, the name gives no indication of its tax-exempt status. The accountant could only emphasize the tax-exempt status of the entity if the financial statements disclose information about that status. For example, the net income caption could be "net income (the entity does not incur income taxes)." The accountant could therefore add a paragraph such as the following to the compilation report.

The entity does not incur income taxes and instead its taxable income is included in the personal taxable income of the individual stockholders and taxed accordingly.

It is not appropriate to modify a review report on financial statements that do not include disclosures by simply adding a general statement to the effect that substantially all disclosures have been omitted. The omission of material disclosures is a departure from the OCBOA and should be treated as such in the review report. Consequently, the review report should be modified to include the omitted disclosures or, if the details to be disclosed have not been determined, to identify the specific nature of the omitted disclosures. Because of those requirements, accountants ordinarily should not accept an engagement to review financial statements that omit substantially all disclosures.

Basis of Accounting Not Disclosed. SAS No. 62 and Interpretation 14 require disclosure of the use of an OCBOA and how the basis used differs from generally accepted accounting principles. Omission of that disclosure requires modification of the accountant's compilation or review report for a departure from the basis of accounting unless management elects to omit substantially all disclosures. If substantially all disclosures are omitted, Paragraph 20 of SSARS No. 1 requires that either the financial statements or the accountant's compilation report disclose the other comprehensive basis of accounting used. It does not require disclosure of how the basis differs from generally accepted accounting principles or that the basis is a comprehensive basis of accounting other than generally accepted accounting principles. The following observations may be helpful:

- a. If the financial statements do not disclose the other comprehensive basis of accounting used, the accountant's compilation report only needs to disclose the basis.
- b. Additional disclosure is not prohibited. Paragraph 22 of SSARS No. 1 provides an example of report disclosure that goes beyond the requirement of Paragraph 20 by also saying that the basis used is a comprehensive basis of accounting other than generally accepted accounting principles. For example, the report might say, "The financial statements have been prepared on the accounting basis used by the company for federal income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles."

Only Selected Information Is Disclosed. If compiled financial statements disclose only selected information, the disclosures should be labeled "SELECTED INFORMATION—Substantially All Required Disclosures Are Not Included," and a paragraph describing the omission of substantially all disclosures should be added to the

compilation report. However, Interpretation 22 of SSARS No. 1 (AR 9100.85–.88) states that such a label would not be appropriate when notes to financial statements contain *more than a few* selected disclosures. In other words, if financial statements contain all but a few required disclosures, such a label should not be used. The Interpretation does not define how many disclosures constitute *more than a few*; thus, the ultimate determination is left to the accountant's judgment based on the particular facts and circumstances. It does, however, declare that when only one or two required notes are missing, the financial statements do not omit *substantially* all disclosures. For instance, financial statements that include all material notes, except for the one on lease disclosures as required by SFAS No. 13 (FASB ASC 840), do not omit substantially all disclosures. In that case, the notes to the financial statements should not bear the label indicating that substantially all disclosures have been omitted, and the accountant's compilation report should be modified for the missing GAAP disclosure.

Departures from an OCBOA. Accountants who become aware of material measurement departures from the OCBOA during the course of a compilation or review engagement have three possible courses of action:

- a. Persuade the client to revise the statements to conform with the OCBOA.
- b. Refer to the departure in the compilation or review report.
- c. Withdraw from the engagement.

Obviously, convincing the client to revise the statements is preferable. If that is not possible, reporting the departure in the compilation or review report is appropriate unless the accountants conclude that management's intention is to mislead the reader. If modifying the report to disclose the departure is not adequate and the client refuses to revise the statements, the accountants should withdraw from the engagement and consider consulting legal counsel.

If modifying the compilation or review report is appropriate, the nature of the OCBOA departure should be disclosed in a separate paragraph, and the effects (dollar amount) of the departure should be disclosed if known. If the effects are not known, the accountants are not required to determine them, but must state in the report that no determination of the effects of the departure has been made.

When there are significant OCBOA departures (whether measurement or disclosure), Interpretation 7 of SSARS No. 1 (AR 9100.23–.26) indicates that the accountants may wish to emphasize the limitations of financial statements having significant OCBOA departures in a separate explanatory paragraph in their compilation or review report, separate from the paragraph describing the departure. (Accountants cannot modify compilation or review reports to indicate that the financial statements are not presented fairly in conformity with an OCBOA since an adverse opinion is only relevant in an audit engagement.) In deciding whether to include an explanatory paragraph, the accountants should consider—

- a. the possible dollar magnitude of the departures,
- b. the significance of the affected items to the entity,
- c. the pervasiveness and overall impact of the misstatement, and
- d. whether the effects of the departure have been disclosed.

The separate explanatory paragraph, which generally should be presented as the last paragraph of the report, might read as follows:

Because the significance and pervasiveness of the matters discussed above make it difficult to assess their impact on the financial statements taken as a whole, users of these financial statements should recognize that they might reach different conclusions about the Company's assets, liabilities, equity, revenues, and expenses if they had access to revised financial statements prepared in conformity with the income tax basis of accounting.

Statement of Cash Flows Is Omitted. OCBOA financial statements need not present a statement of cash flows. Therefore, failing to present a statement of cash flows is not a departure from the OCBOA, and the compilation or review report should not be modified.

Reference to the Work of Another Accountant or Auditor. According to a footnote in AR 100.38, in their review report on financial statements, accountants may refer to the work of other accountants or auditors who have reviewed or audited a portion of the financial statements. If such a reference is made, the report should indicate the magnitude of the portion of the financial statements reviewed or audited by the other accountants or auditors. The following is an example first paragraph of the principal accountants' review report when other accountants (or auditors) have reviewed (or audited) certain subsidiaries that are included in consolidated income tax basis financial statements:

We have reviewed the accompanying consolidated statement of assets, liabilities, and stockholders' equity—income tax basis of XYZ Company (a corporation) and subsidiaries as of December 31, 20X7, and the related consolidated statements of revenues and expenses—income tax basis and changes in stockholders' equity—income tax basis for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these consolidated financial statements is the representation of the management of XYZ Company. We did not review the financial statements of B Company, a wholly owned subsidiary, whose statements reflect total assets and revenues constituting 8% and 11%, respectively, of the related consolidated totals. These statements were reviewed (audited) by other accountants (auditors) whose report thereon has been furnished to us, and the results of our review expressed herein, insofar as it relates to the amounts included for B Company, is based solely upon the report of the other accountants (auditors).

An example of the final paragraph of the previously described review report follows:

Based on our review and the report of the other accountants (auditors) discussed above, we are not aware of any material modifications that should be made to the accompanying consolidated financial statements in order for them to be in conformity with the income tax basis of accounting.

Reporting When There is a Change of Accountants. When an accountant is reporting on comparative financial statements of a nonissuer that include statements of a prior period previously reported on by another accountant, he or she has several options regarding the report on the prior period financial statements:

- a. Attempt to have the predecessor accountant reissue his or her report.
- b. Make reference to the predecessor accountant's report in his or her own report.
- c. Perform a compilation, review, or audit of the prior period financial statements and issue his or her own report.

Restated Prior-period Financial Statements. If the current period accountant is not a continuing accountant (i.e., the prior period was reported on by a predecessor) and the financial statements of the prior period have been restated, there are three options:

- a. The predecessor accountant can reissue his or her report. If the predecessor accepts the reporting obligation and reissues his report on the restated financial statements, he should perform certain procedures required by SSARS No. 2 and dual-date his report.
- b. The successor accountant can report on the financial statements for both years. If the successor chooses this option and reports on the restated financial statements, he must perform a compilation or review in accordance with SSARS No. 1 or perform an audit in accordance with the auditing standards that relate to restated financial statements. A successor's report on restated prior period financial statements should not refer to the predecessor's previously issued report.
- c. As a result of the option added by SSARS No. 12, the successor accountant can also report on the restatement adjustment and say that other accountants previously reported on the prior-period financial statements before the restatement.

Use of Emphasis Paragraphs in Compilation and Review Reports

Accountants frequently ask whether they can add a paragraph to a compilation or review report to emphasize a matter regarding the financial statements. Emphasis paragraphs generally call attention to matters disclosed in the financial statements such as going-concern problems, litigation matters, or related-party transactions. SSARS No. 1 (AR 100.54) states, "Emphasis paragraphs are never required; they may be added solely at the accountant's discretion."

While accountants generally can make whatever disclosures they deem appropriate in their compilation or review report, best practices indicate that accountants avoid using emphasis paragraphs whenever possible. Such paragraphs require the accountants to choose the information in the financial statements that should be emphasized. There is no authoritative criteria for deciding when to use an emphasis paragraph because the presumption is that all disclosures ordinarily included in OCBOA financial statements are important. Thus, choosing one matter to discuss in an emphasis paragraph could place undue emphasis on that matter and detract from other important disclosures. However, accountants may decide that an emphasis paragraph is necessary to highlight an unusual or important matter that is disclosed in the financial statements, such as significant related party transactions or an unusually important subsequent event.

In accordance with SSARS No. 1 the emphasis paragraph should not introduce new information to the reader of the financial statements. Accordingly, emphasis paragraphs should only highlight or emphasize a matter already disclosed in the financial statements. If the financial statements are deficient or do not contain a needed disclosure (in full disclosure financial statements) and the client does not correct the financial statements, the accountant is required to state, in a separate paragraph of the report, that the financial statements contain an OCBOA departure. This required paragraph is different from a voluntary emphasis paragraph because its purpose is to make the financial statement reader aware of a deficiency in the financial statements.

Best practices indicate that the following guidelines should be followed:

- a. Emphasis paragraphs should not contain information about procedures the accountant has or has not performed.
- b. Emphasis paragraphs should not contain information about the accountant's conclusions or opinions.

Emphasis Paragraphs in Compiled Financial Statements That Omit Substantially All Disclosures. Accountants sometimes question whether they can include an emphasis paragraph in the accountant's report when the financial statements omit substantially all disclosures. In SSARS No. 1 (AR 100.55), "an accountant should not include an emphasis paragraph in a compilation report on financial statements that omit substantially all disclosures unless the matter is disclosed in the financial statements." A footnote within AR 100.55 notes that the accountant may include an emphasis paragraph on a matter when management has presented selected information, even though substantially all disclosures have been omitted, as long as the matter discussed in the emphasis paragraph is disclosed in the selected information.

Uncertainties about the Entity's Ability to Continue as a Going Concern. Accountants are not required to add an explanatory paragraph for going concern matters to their compilation or review report. However, SSARS No. 1 (AR 100.54) and Interpretation 29 of SSARS No. 1 (AR 9100.120–.129) note that an emphasis paragraph may be added when a going concern uncertainty exists.

Another difference between audit and compilation or review reports is that SAS No. 59 (AU 341) requires that the terms *substantial doubt* and *going concern* be used in the explanatory paragraph when the auditor concludes that substantial doubt exists. Neither SSARS No. 1 nor Interpretation 29 requires the use of the terms *substantial doubt* or *going concern* in the wording of the optional emphasis paragraph.

The following is an example explanatory paragraph from Interpretation 29 that may be added to the accountants' report:

As discussed in Note X, certain conditions indicate that the Company may be unable to continue as a going concern. The accompanying financial statements do not include any adjustments that might be necessary should the Company be unable to continue as a going concern.

If going concern matters are not disclosed adequately in full disclosure financial statements, accountants should modify their reports for the departure from the OCBOA.

Inconsistencies. A change in accounting principle does not require modifying the accountant's compilation or review report or adding an emphasis paragraph. However, an accountant is not precluded from adding an emphasis paragraph about the change as long as the change is disclosed in the financial statements. SSARS No. 1 prohibits addressing information in an emphasis paragraph that is not disclosed in the financial statements. Therefore, an emphasis paragraph about a change in accounting principle should not be added to the accountant's compilation report on financial statements that omit substantially all disclosures unless the financial statements include disclosure of the change. That is not likely to be practical. If accountants choose to add a paragraph to their report highlighting the change in accounting principle, the following language might be used:

As discussed in Note X, in 20X9 the Company changed its policy for determining cash equivalents.

If the change in accounting principle is not properly accounted for or appropriate disclosures are not included in the financial statements, accountants should modify their compilation or review reports because of a departure from the OCBOA.

A change in tax law is not considered to be a change in accounting principle in tax basis financial statements. On the other hand, a change in the way a company treats an item for tax purposes (assuming tax law did not change) is considered a change in accounting principle in tax basis financial statements.

Change in Basis of Accounting. Companies sometimes change the basis of accounting used to present their financial statements from an OCBOA to GAAP, from GAAP to OCBOA, or from one OCBOA to another. For example, a company that used the tax basis to prepare its financial statements in prior years may decide to use GAAP to prepare its current-year statements. Audit literature states that such changes may be, but are not required to be, mentioned in an explanatory paragraph to the audit report. While SSARS No. 1 does not address changes in the comprehensive basis of accounting, SSARS No. 1 (AR 100.54), states, "Emphasis paragraphs are never required; they may be added solely at the accountant's discretion." Accordingly, if the financial statements appropriately disclose the change in basis, an explanatory paragraph such as the following may be, but is not required to be, added to the compilation or review report:

As discussed in Note X to the financial statements, in 20X7 the Company adopted a policy of preparing its financial statements on the basis of accounting it uses for federal income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles. The 20X6 financial statements have been restated on the same basis of accounting.

However, if the statements do not appropriately disclose the change in basis, the compilation or review report should be modified for a departure from OCBOA

Use of Different Bases of Accounting for Financial Statements of the Same Period. Companies may request that accountants compile or review financial statements for the same period based on different bases of accounting. For example, a regulatory agency might require that a company use the accounting basis it uses for preparing its federal income tax returns to prepare financial statements it submits to the agency, while a bank may request GAAP financial statements for the same period of time. SAS No. 62 does not require auditors to add an explanatory paragraph to their audit report to highlight the fact that both GAAP and OCBOA financial statements exist for the same period of time. SSARS No. 1 does not address that situation.

Restricting the Use of Reports

SSARS No. 1 (AR 100.59–.68) describes the circumstances in which accountants should restrict their reports, defining the terms *general use* and *restricted use*, and specifying the language that should be used in accountant's reports that are restricted as to use.

Restricted use reports are intended only for one or more specified third parties. All other reports are considered to be general use reports. SSARS No. 1 indicates that the use of a accountant's report should be restricted when the

subject matter of the report or presentation being reported on is based on measurement or disclosure criteria in a contractual agreement or regulatory provisions that are not in conformity with GAAP or an OCBOA because the basis, assumptions, or purpose of such presentations are developed for and directed only to the parties to the agreement and may be misunderstood by others.

Some CPAs have asked, however, if it is permissible to restrict the use of compilation and review reports that are not otherwise required by professional standards to be restricted. The answer is yes, such restriction is permissible. Although there are circumstances when the report is required to carry a use restriction, the accountant is not prohibited from restricting the use of any report. Best practices indicate that a practitioner who believes that restriction may be desirable consider the following issues:

- Will the proposed restriction mitigate the practitioner's risk of lawsuits?
- Will the client accept the proposed restriction?

If the accountant issues a combined report that covers subject matter required to be restricted, as well as subject matter not required to be restricted, the accountant should restrict the use of all of the subject matter. However, when required by law to issue a separate restricted-use report in a document that also contains a general-use report, the restricted-use report remains restricted as to use, and the general-use report continues for general use. The restricted-use subject matter, however, should be clearly labeled.

Accountants may be asked to add other specified parties after the completion of the compilation or review engagement. If the accountant agrees to such a request, the accountant should obtain affirmative acknowledgment, preferably in writing, from the other parties of their understanding of the nature of the engagement, the measurement or disclosure criteria used in the engagement, and the related report. If the other parties are added after the accountant has issued his or her report, the report may be reissued or the accountant may provide written notification that the other parties have been added as specified parties. If the report is reissued, the report date should not be changed. Written notification of the addition of other specified parties should state that no procedures have been performed subsequent to the date of the report.

According to SSARS No. 1, the restricted use of accountant's report should (a) indicate that the report is intended solely for the information and use of the specified parties, (b) identify the specified parties, either in the report or by referring to the specified parties listed elsewhere in the report, and (c) state that the report is not intended to be and should not be used by anyone other than the specified parties. AR 100.68 provides the following sample report language, which should be used as the last paragraph in the restricted use accountant's report:

This report is intended solely for the information and use of [Specified Parties] and is not intended to be and should not be used by anyone other than these specified parties.

Note that the report language restricts the use, not the distribution, of the report. Because of the reasons described earlier in this lesson the accountant should consider informing his or her client that restricted-use reports are not intended for distribution to nonspecified parties. The accountant, however, is not responsible for controlling a client's distribution of restricted-use reports.

Association with Client-prepared Financial Statements

Sometimes, a client includes the accountants' names in a loan proposal, prospectus, or other third-party written communication that includes client-prepared financial statements. If the client uses financial statements that were previously compiled or reviewed by the accountants, best practices indicate that the accountants should insist that their report accompany the statements.

If the financial statements are client-prepared, however, the accountants must insist either that reference to their name be removed from the client-prepared document or that the statements be accompanied by an indication that they have not compiled or reviewed them and take no responsibility for them. The following language is based on the guidance in SSARS No. 1 (AR 100.03) and may be used to indicate that the accountants have not compiled or reviewed the unaudited financial statements:

The accompanying statement of assets, liabilities, and equity—income tax basis of XYZ Company as of December 31, 20X7, and the related statement of revenues, expenses, and retained earnings—income tax basis for the year then ended were not audited, reviewed, or compiled by us and, accordingly, we do not express an opinion or any other form of assurance on them.

If the accountants become aware that their name has been used improperly in any client-prepared document containing unaudited financial statements, they should:

- a. Advise the client that the use of their name is inappropriate.
- b. Consider what other actions might be appropriate, including consultation with their attorney.

Reporting on Compiled or Reviewed Supplementary Information

SSARS No. 1 (AR 100.83) requires that the accountants compile supplementary information presented with the basic financial statements that the accountants also have compiled. If supplementary information is presented with compiled OCBOA financial statements, accountants must describe in the compilation report, or in a separate report, the degree of responsibility, if any, taken with regard to the supplementary information.

SSARS No. 1 (AR 100.83) clarifies that a separate report on the supplementary information is permitted. In addition, it states that, if a separate report is issued, the accountants' report should indicate that:

- a. The supplementary information is presented only for supplementary analysis purposes.
- b. The information has been compiled from information that is the representation of management, without audit or review.
- c. The accountants do not express an opinion or any other form of assurance on the supplementary information.

When reviewed OCBOA financial statements are accompanied by supplementary information, SSARS No. 1 (AR 100.83) allows accountants to either review or compile the supplementary information. If the accountants applied inquiry and analytical procedures to the supplementary information, either the accountants' review report on the basic financial statements or a separate report accompanying the supplementary information should indicate that—

- a. the review of the basic financial statements was made for the purpose of expressing limited assurance that there are no material modifications necessary for the financial statements to be in conformity with the OCBOA.
- b. the supplementary information is presented only for supplementary analysis purposes.
- c. the supplementary information has been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements.
- d. the accountants did not become aware of any material modifications that should be made to the supplementary information.

If the accountants did not subject the supplementary information to inquiry and analytical procedures, the review report on the basic financial statements should include items a and b, but items c and d should be modified as follows:

- a. The information was not subjected to the inquiry and analytical procedures applied in the review of the basic financial statements, but was compiled from information that is the representation of management, without audit or review.
- b. The accountants do not express an opinion or any other form of assurance on the supplementary information.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. Jason created an auditors' report on his firm's letterhead. What would be an appropriate title?
 - a. INDEPENDENT AUDITORS' REPORT.
 - b. Because the report is on letterhead, an additional title is not necessary.
 - c. ACCOUNTANTS' REPORT ON FINANCIAL STATEMENTS.
 - d. ACCOUNTANTS' REPORT.
22. Layla is engaged to prepare a compilation report on the Black & Blue, Inc.'s income tax basis financial statements. In which of the following scenarios has she correctly followed one of the general reporting requirements?
 - a. Layla addresses the report to the stockholders and includes Black & Blue's street address.
 - b. Layla uses the date she began preparing the report as the report date.
 - c. Layla refers to the financial statements using the prescribed order.
 - d. The report is printed on firm letterhead, and Layla uses a stamp to sign the report.
23. What type of report provides limited assurance on the financial statements?
 - a. Review report.
 - b. Compilation report.
 - c. Auditor's report.
24. Leslie accepts an engagement to provide management-use-only financial statements. Which of the following procedures must be part of Leslie's engagement?
 - a. Referencing the United States of America as the country of origin.
 - b. Making specific written communications to management in an engagement letter.
 - c. Printing "Restricted for Management's Use Only" on only the first page of the statements.
 - d. Preparing a compilation report to accompany the financial statements.
25. Liz would like to add an emphasis paragraph to her compilation report on a company's income tax basis financial statements. Which of the following scenarios best illustrates how she should proceed?
 - a. Liz cannot add an emphasis paragraphs because they are prohibited from all compilation reports.
 - b. While Liz can include an emphasis paragraph, such an inclusion should be avoided if possible.
 - c. If an emphasis paragraph is necessary for readers to understand the financial statements, Liz is required to include it.
26. When using an emphasis paragraph in compilation and review reports, which of the following statements is most accurate?
 - a. Emphasis paragraphs should be used to introduce new information to the reader of the financial statements.

- b. Emphasis paragraphs should highlight a matter already disclosed in the financial statements.
 - c. Emphasis paragraphs should contain opinions reached by the accountant.
 - d. Accountants are strongly encouraged to include information regarding procedures performed as well as not performed by the accountant.
27. Which of the following statements is most accurate regarding if accountants should include emphasis paragraphs in compiled financial statements that *omit substantially all disclosures*?
- a. Accountants should never include emphasis paragraphs in compiled financial statements that omit substantially all disclosures.
 - b. Accountants should not disclose an emphasis paragraph in a compilation report that omits substantially all disclosures unless the matter is disclosed in the financial statements.
28. Which of the following statements regarding uncertainties about an entity's ability to continue as a going concern is most accurate?
- a. According to SSARS No.1, accountants are required to use the terms substantial doubt or going concern in the wording of the optional emphasis paragraph.
 - b. According to SSARS No. 1, an emphasis paragraph may be added when a going concern uncertainty exists.
29. Michael is required to include the following explanatory paragraph in a compilation report on a company's income tax basis financial statements.

As discussed in Note X, in 2008 the Company changed its policy for determining cash equivalents.

Why would this paragraph be included?

- a. The company changed the basis of accounting from OCBOA to GAAP.
 - b. The company changed its basis of accounting.
 - c. The company changed an accounting principle.
 - d. A change in tax law.
30. Luanne is hired to review a company's income tax basis financial statements. She also compiles supplementary information that must be presented along with the basic financial statements. Luanne presents the supplementary information in her review report. Which of the following must be indicated in Luanne's report?
- a. Luanne is not aware of any material modifications that should be made to the supplementary information.
 - b. Luanne elected not to put the supplementary information in a separate report, as permitted by SSARS No. 1.
 - c. Luanne does not express an opinion or any assurance on the supplementary information.
 - d. The supplementary information has been subjected by Luanne to the inquiry and analytical procedures applied in the financial statement review.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

21. Jason created an auditors' report on his firm's letterhead. What would be an appropriate title? **(Page 61)**
- a. **INDEPENDENT AUDITORS' REPORT.** [This answer is correct. According to guidance found in SAS No. 58, an auditors' report is required to be titled, and the word "independent" must be included.]
 - b. Because the report is on letterhead, an additional title is not necessary. [This answer is incorrect. If Paul created a compilation or review report on letterhead, a title would not be necessary, but one could be used if desired.]
 - c. **ACCOUNTANTS' REPORT ON FINANCIAL STATEMENTS.** [This answer is incorrect. For a compilation or review report, Paul could use this title.]
 - d. **ACCOUNTANTS' REPORT.** [This answer is incorrect. This title could be used if Paul had created a compilation or a review report.]
22. Layla is engaged to prepare a compilation report on the Black & Blue, Inc.'s income tax basis financial statements. In which of the following scenarios has she correctly followed one of the general reporting requirements? **(Page 61)**
- a. Layla addresses the report to the stockholders and includes Black & Blue's street address. [This answer is incorrect. The city and state are commonly included, but not the post office box number or the street address. Many firms, however, will also omit the city and state if the report is addressed to widely dispersed stockholders.]
 - b. Layla uses the date she began preparing the report as the report date. [This answer is incorrect. The report date for a compilation report should generally be the date that the financial statements are "read" (as the term "read" is used in SSARS No. 1).]
 - c. Layla refers to the financial statements using the prescribed order. [This answer is incorrect. There is no prescribed order for how the financial statements must be referred to in the report. Layla can refer to them as she sees fit. In practice, however, they are usually referred to in the order that they are presented.]
 - d. **The report is printed on firm letterhead, and Layla uses a stamp to sign the report.** [This answer is correct. An accountant's report must contain the signature of the firm or the accountant, whichever is appropriate, and for compilations and reviews, the signature can be stamped, electronic, typed, or manually written. Audits require the manual or printed signature of the firm.]
23. What type of report provides limited assurance on the financial statements? **(Page 62)**
- a. **Review report.** [This answer is correct. A review allows the accountant to express a limited assurance on the financial statements. The accountant will perform inquiry and analytical procedures to reasonably determine that material modification are not needed for the financial statements to be in conformity with its basis of accounting (GAAP, income tax basis, etc.).]
 - b. Compilation report. [This answer is incorrect. In a compilation, the accountant would not express any type of assurance on the financial statements. The accountant merely compiles the financial statements that they submit to clients or others.]
 - c. Auditor's report. [This answer is incorrect. Performing an audit should allow the accountant to provide a reasonable basis for expressing an opinion about whether the financial statements (taken as a whole) are free from material misstatement. The accountant must perform more procedures to produce an auditors' report than for a compilation or review report.]

24. Leslie accepts an engagement to provide management-use-only financial statements. Which of the following procedures must be part of Leslie's engagement? **(Page 64)**
- a. Referencing the United States of America as the country of origin. [This answer is incorrect. This is necessary for an auditor's report and allowed for compilation and review reports; however, it is not necessary in management-use-only financial statements.]
 - b. Making specific written communications to management in an engagement letter. [This answer is correct. Preferably, the engagement letter would be signed by management.]**
 - c. Printing "Restricted for Management's Use Only" on only the first page of the statements. [This answer is incorrect. The reference must be printed on each page of the financial statements, not just the first page.]
 - d. Preparing a compilation report to accompany the financial statements. [This answer is incorrect. If management-use-only financial statements are not reasonably expected to be used by third parties, Leslie does not have to prepare a compilation report.]
25. Liz would like to add an emphasis paragraph to her compilation report on a company's income tax basis financial statements. Which of the following scenarios best illustrates how she should proceed? **(Page 68)**
- a. Liz cannot add an emphasis paragraphs because they are prohibited from all compilation reports. [This answer is incorrect. Authoritative literature does not prohibit Liz from including an emphasis paragraph in her compilation report under these circumstances.]
 - b. While Liz can include an emphasis paragraph, such an inclusion should be avoided if possible. [This answer is correct. Liz is free to make whatever disclosures she deems necessary. However, as there is no authoritative criteria for emphasis paragraphs because it is presumed that all disclosures ordinarily included in the income tax basis financial statements are important; choosing one matter to emphasis could place undue importance on it. Therefore, if possible, Liz should avoid an emphasis paragraph.]**
 - c. If an emphasis paragraph is necessary for readers to understand the financial statements, Liz is required to include it. [This answer is incorrect. Authoritative literature does not require accountants to add emphasis paragraphs to compilation or review reports.]
26. When using an emphasis paragraph in compilation and review reports, which of the following statements is most accurate? **(Page 68)**
- a. Emphasis paragraphs should be used to introduce new information to the reader of the financial statements. [This answer is incorrect. According to SSARS No. 1, the emphasis paragraph should not introduce new information to the reader of the financial statements.]
 - b. Emphasis paragraphs should highlight a matter already disclosed in the financial statements. [This answer is correct. Emphasis paragraphs should only highlight or emphasize a situation already disclosed in the financial statements.]**
 - c. Emphasis paragraphs should contain opinions reached by the accountant. [This answer is incorrect. Best practices indicate that emphasis paragraphs should not contain information regarding the accountant's conclusions or opinions.]
 - d. Accountants are strongly encouraged to include information regarding procedures performed as well as not performed by the accountant. [This answer is incorrect. Best practices indicate that emphasis paragraphs should not contain information about procedures the accountant has or has not performed.]

27. Which of the following statements is most accurate regarding if accountants should include emphasis paragraphs in compiled financial statements that *omit substantially all disclosures*? **(Page 68)**
- a. Accountants should never include emphasis paragraphs in compiled financial statements that omit substantially all disclosures. [This answer is incorrect. The accountant may include an emphasis paragraph on a matter when management has presented selected information, even though substantially all disclosures have been omitted, as long as the matter discussed in the emphasis paragraph is disclosed in the selected information.]
 - b. Accountants should not disclose an emphasis paragraph in a compilation report that omits substantially all disclosures unless the matter is disclosed in the financial statements. [This answer is correct. According to paragraph 55 and a footnote within that paragraph in SSARS No. 1, “an accountant should not include an emphasis paragraph in a compilation report on financial statements that omit substantially all disclosures unless the matter is disclosed in the financial statements.”]**
28. Which of the following statements regarding uncertainties about an entity's ability to continue as a going concern is most accurate? **(Page 68)**
- a. According to SSARS No.1, accountants are required to use the terms substantial doubt or going concern in the wording of the optional emphasis paragraph. [This answer is incorrect. Neither SSARS No. 1 nor Interpretation 29 requires the use of the terms substantial doubt or going concern in the wording of the optional emphasis paragraph.]
 - b. According to SSARS No. 1, an emphasis paragraph may be added when a going concern uncertainty exists. [This answer is correct. SSARS No. 1 and Interpretation 29 note that an emphasis paragraph may be added when a going concern, uncertainty exists.]**
29. Michael is required to include the following explanatory paragraph in a compilation report on a company's income tax basis financial statements. **(Page 69)**

As discussed in Note X, in 2008 the Company changed its policy for determining cash equivalents.

Why would this paragraph be included?

- a. The company changed the basis of accounting from OCBOA to GAAP. [This answer incorrect. audit literature states that such changes may be, but are not required to be, mentioned in an explanatory paragraph to the audit report.]
- b. The company changed its basis of accounting. [This answer is incorrect. A change in the basis of accounting (e.g., from the income tax basis to GAAP) would be indicated by a different kind of explanatory note. However, Michael would not be required to include such a note if the financial statement adequately disclosed the change.]
- c. The company changed an accounting principle. [This answer is correct. Michael is not required to modify his compilation report for a change in accounting principle, if that change is properly accounted for/disclosed in the financial statements. However, he could choose to add an explanatory paragraph to highlight the change, and this would be an example of such a paragraph.]**
- d. A change in tax law. [This answer is incorrect. A change in tax law is not considered to be a change in accounting principle in tax basis financial statements; therefore, would not be a valid reason to include the above paragraph.]

30. Luanne is hired to review a company's income tax basis financial statements. She also compiles supplementary information that must be presented along with the basic financial statements. Luanne presents the supplementary information in her review report. Which of the following must be indicated in Luanne's report? **(Page 71)**
- a. Luanne is not aware of any material modifications that should be made to the supplementary information. [This answer is incorrect. Luanne could not make this statement if she did not review the supplementary information (i.e., perform analytical procedures and make inquiries on it).]
 - b. Luanne elected not to put the supplementary information in a separate report, as permitted by SSARS No. 1. [This answer is incorrect. How to present the supplementary information (in the review report or as a separate report) is up to Luanne and need not be disclosed in the report.]
 - c. **Luanne does not express an opinion or any assurance on the supplementary information. [This answer is correct. Luanne cannot express an opinion on the supplementary information because she compiled it. In addition Luanne must include in her review report: "The supplementary information was not subjected to the inquiry and analytical procedures applied in the review of the basic financial statements, but was compiled from information that is the representation of management, without audit or review."]**
 - d. The supplementary information has been subjected by Luanne to the inquiry and analytical procedures applied in the financial statement review. [This answer is incorrect. As Luanne only compiled the supplementary information (i.e., she did not review it), she would not have subjected it to any inquiry or analytical procedures.]

AUDITORS' REPORTS

The Standard Report

The objective of an audit is to provide a reasonable basis for expressing an opinion about whether the financial statements taken as a whole are free from material misstatement. It involves examining evidence (on a test basis) supporting financial statement amounts, assessing the accounting principles used and significant estimates made by management, and evaluating the overall presentation.

The reporting standards for auditors' reports on OCBOA financial statements are prescribed by SAS No. 62 (AU 623). The SAS also has illustrations of reports. The reporting standards are similar to those for the report on GAAP basis financial statements prescribed by SAS No. 58 (AU 508) with one exception—they state that an additional paragraph should be added that states the basis of presentation, refers to the note describing the basis, and states that the basis of presentation is a comprehensive basis of accounting other than generally accepted accounting principles. In addition, the standards require the audit report on OCBOA financial statements to state—

- a. the financial statements identified in the report were audited.
- b. the financial statements are the responsibility of management, and the auditors' responsibility is limited to expressing an opinion on the financial statements based on the audit.
- c. the audit was conducted in accordance with generally accepted auditing standards and identify the United States of America as the country of origin of those standards.
- d. generally accepted auditing standards require audits to be planned and performed to obtain reasonable assurance about whether the financial statements are free of material misstatement. Audit procedures include examining, on a test basis, evidence that supports the amounts and disclosures in the financial statements, assessing the appropriateness of the accounting principles used by management and the significant estimates made by management, and assessing the appropriateness of the overall financial statement presentation.
- e. the auditors believe the procedures applied provide a reasonable basis for the opinion presented.
- f. whether the financial statements are presented fairly, in all material respects, in accordance with the OCBOA.

The difference between GAAP and the basis of presentation need not be described in the auditors' report. Rather, a description of the basis and the primary differences from GAAP should be included in the notes to the financial statements. The auditors' report is illustrated in Exhibit 2-3.

Exhibit 2-3

Standard Audit Report—Income Tax Basis of Accounting

INDEPENDENT AUDITORS' REPORT

To the Board of Directors
XYZ Company
City, State

We have audited the accompanying statement of assets, liabilities, and stockholders' equity—income tax basis of XYZ Company as of December 31, 20X8, and the related statements of revenues and expenses—income tax basis and changes in stockholders' equity—income tax basis for the year then ended. These financial statements are the responsibility of the Company's management. 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 of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared on the basis of accounting the Company uses for income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

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, 20X8, and its revenues and expenses and changes in stockholders' equity for the year then ended, on the basis of accounting described in Note X.

Firm's signature

February 14, 20X9

* * *

Modifications to the Auditors' Report

SAS No. 58, *Reports on Audited Financial Statements* (AU 508), states that the auditors' report should be modified in the following situations:

- a. *Qualified Opinion Is Expressed.* A qualified opinion (also referred to as an "except for" opinion) indicates that the auditors are satisfied with the financial statements taken as a whole except for a particular item. Qualified opinions should be issued when there is a material departure from the OCBOA (including inadequate disclosure) or the scope of the audit is affected by conditions that preclude auditors from applying necessary audit procedures (referred to as a scope limitation.) Extremely material or pervasive circumstances may require an adverse opinion when a departure from the OCBOA exists or a disclaimer of opinion when a scope limitation exists.
- b. *Adverse Opinion Is Expressed.* Auditors give an adverse opinion when they believe departures from the OCBOA are so material or pervasive that the financial statements are not fairly presented in accordance with the OCBOA. Adverse opinions are rare in practice because their implications are so serious that they usually cause the company to correct the financial statements.
- c. *Disclaimer of Opinion Is Expressed.* A disclaimer of opinion states that the auditors do not express an opinion on the reasonableness of the financial statements. Generally, auditors issue a disclaimer of opinion when they are faced with a scope limitation so significant that they believe a qualified opinion is not appropriate.
- d. *Additional Explanatory Language Is Added.* Auditors may be faced with circumstances that, while not precluding an unqualified opinion, require explanatory language to be added to the standard report. According to SAS No. 62 (AU 623.31), circumstances that require auditors to add explanatory language to their unqualified opinion on OCBOA financial statements include the following:
 - (1) Inconsistencies in applying accounting principles
 - (2) Uncertainties about the entity's ability to continue as a going concern
 - (3) Expressing an opinion on prior-year financial statements that is different from the opinion previously expressed
 - (4) Reference to work of another auditor

Exhibit 2-4 lists various circumstances and describes how the standard audit report should be modified in each situation. The following paragraphs discuss common modifications to auditors' reports on OCBOA financial statements in further detail.

Exhibit 2-4

Modifying the Auditors' Standard Report

Type of Report	Circumstance	Materiality ^a	How to Modify the Standard Report
QUALIFIED OPINION	Departure from OCBOA (measurement or disclosure)	Material	Add a separate explanatory paragraph preceding the opinion paragraph and qualify the opinion (except for).
	Scope limitation	Material	Modify the scope paragraph, add a separate explanatory paragraph preceding the opinion paragraph, and qualify the opinion (except for).
ADVERSE OPINION	Pervasive departure from OCBOA	Very material	Add a separate explanatory paragraph preceding the opinion paragraph and modify the opinion to state "do not present fairly in conformity with (the OCBOA)."
DISCLAIMER OF OPINION	Pervasive scope limitation	Very material	Modify the introductory paragraph, delete the scope paragraph, add a separate explanatory paragraph, and modify the opinion paragraph to state "we do not express an opinion."
UNQUALIFIED OPINION WITH REQUIRED EXPLANATORY LANGUAGE	Not independent and a non-public company	n/a	Issue a SSARS No. 1 compilation report that states the lack of independence.
	Unaudited financial statements of a nonpublic company	n/a	Issue a SSARS No. 1 compilation or review report.
	Going concern uncertainty or inconsistent application of accounting principles	Material	Add a separate explanatory paragraph following the opinion paragraph discussing the matter, but issue an unqualified opinion.
	Auditors refer to the report of another auditor that is used as a basis for their opinion	n/a	Disclose the other auditor's work in the introductory paragraph and refer to the other auditor in the opinion paragraph, but issue an unqualified opinion.
	Auditors revise their opinion on prior-period financial statements in comparative financial statements	n/a	Add a separate paragraph preceding the opinion paragraph disclosing the reasons for the different opinion.
	Prior-period financial statements were audited by a predecessor whose report is not presented	n/a	Modify the introductory paragraph.

Type of Report	Circumstance	Materiality ^a	How to Modify the Standard Report
	Prior-period financial statements were audited by a predecessor whose report is not presented and are restated	n/a	Modify the introductory paragraph, and add a separate paragraph following the opinion paragraph if the successors are able to satisfy themselves about the appropriateness of the restatement.
	Auditors wish to emphasize a matter regarding the financial statements	n/a	Add a separate paragraph discussing the matter, but issue an unqualified opinion.

Note:

- ^a If the circumstance is not material to the financial statements taken as a whole, auditors should not modify the standard report.
- ^b ARSC has issued an exposure draft of a proposed SSARSs that would allow an accountant who is not independent to perform a review if the accountant's independence is impaired due to the performance of internal control services on behalf of management. The exposure draft would also allow an accountant to include a general description in the accountant's compilation report as to the reason(s) for an independence impairment.
- ^c In October 2008, the FASB issued an exposure draft of proposed changes concerning going concern considerations. Exposure Draft 2008-02 would create FASB ASC Subtopic 205-30.

* * *

Departures from an OCBOA. Financial statements may contain departures from an OCBOA (for example, tax basis financial statements that fail to include an income tax provision). When OCBOA departures are material, the standard audit report should be modified to express a qualified or adverse opinion. In such cases, a separate explanatory paragraph should disclose all the substantive reasons for the report modification and their principal effects, if reasonably determinable. If the effects of the OCBOA departure cannot be reasonably determined, the auditor should state that fact in the explanatory paragraph. The opinion paragraph of the audit report should state that except for the effects of the departure discussed in the explanatory paragraph, the financial statements present fairly, in all material respects, the assets, liabilities, equity, revenues, and expenses on the basis of accounting described (in the case of a qualified opinion) or that the financial statements do not present the entity's assets, liabilities, equity, revenues, and expenses fairly in accordance with the OCBOA (in the case of an adverse opinion).

Inadequate disclosure is considered a departure from the OCBOA that could cause auditors to express a qualified or adverse opinion. In such cases the audit report should be modified to include a separate explanatory paragraph that either discloses the omitted information or explains the nature of the disclosure and that management considers it impracticable to develop the information. In addition, the opinion paragraph should state that except for the omission of the information discussed in the explanatory paragraph, the financial statements present fairly the assets, liabilities, equity, revenues, and expenses on the OCBOA (or, in the case of an adverse opinion, merely that the financial statements do not present the entity's assets, liabilities, equity, revenues, and expenses fairly in accordance with the OCBOA).

Inconsistencies. Auditors are not required to qualify their opinion because of a change in accounting principle (or change in the method of applying an accounting principle) provided the change is accounted for properly and adequately disclosed in the financial statements. However, they should refer to the change in an explanatory paragraph following the opinion paragraph of their report. The explanatory paragraph should describe the change and refer to the financial statement note that discusses the change and its effect on the financial statements. The following is an example explanatory paragraph:

As discussed in Note X to the financial statements, the Company changed its policy for determining cash equivalents in 20X7.

According to SAS No. 62 (AU 623.31, footnote 36), a change in tax law is not considered to be a change in accounting principle in tax basis financial statements. On the other hand, a change in the way the company treats an item for tax purposes (assuming tax law did not change) is considered a change in accounting principle in tax basis financial statements.

Uncertainties about the Entity's Ability to Continue as a Going Concern. SAS No. 59 (AU 341) notes that auditors have a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern. That responsibility applies to every audit, regardless of whether the financial statements are presented in conformity with GAAP or an OCBOA. If the auditors are uncertain about an entity's ability to continue as a going concern for the next year, they should add an explanatory paragraph following the opinion paragraph of their report. An illustration of such a paragraph follows:

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency. Those conditions raise substantial doubt about the Company's ability to continue as a going concern. Management's plans regarding such matters also are described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Uncertainties Regarding Tax Positions. There may be circumstances when the proper tax treatment of a transaction or item entering into the tax calculation is unclear based on existing tax laws and court cases.

Expressing an Opinion on Prior-year Financial Statements That Is Different from the Opinion Previously Expressed. If auditors express an opinion on prior-period financial statements that differs from their previous opinion, the updated report should disclose all of the substantive reasons for the change in the opinion. Such disclosure should be made in a separate explanatory paragraph that precedes the opinion paragraph of the auditor's report. The explanatory paragraph should disclose:

- a. the date of the auditor's previous report.
- b. the type of opinion previously expressed.
- c. the circumstances or events that caused the auditors to express a different opinion.
- d. the fact that the auditor's updated opinion on the prior-period financial statements is different from the previous opinion on those statements.

For example, if the auditor's report on prior-period modified cash basis financial statements was modified because those statements were affected by a departure from the modified cash basis of accounting and the statements are restated in the current period to conform with the modified cash basis, the auditor's updated report on the prior-period statements should no longer be modified for that departure.

Reference to the Work of Another Auditor. When the auditors' opinion is based, in part, on the report of other auditors, the introductory and opinion paragraphs of the auditors' report should be modified to disclose that fact. An example introductory paragraph of the principal auditors' report when other auditors have audited certain subsidiaries that are included in consolidated income tax basis financial statements follows:

We have audited the accompanying consolidated statements of assets, liabilities, and stockholders' equity—income tax basis of ABC Company (a Texas corporation) and subsidiaries as of December 31, 20X8 and 20X7, and the related consolidated statements of revenues and expenses—income tax basis and changes in stockholders' equity—income tax basis for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We did not audit the financial statements of B Company, a wholly owned subsidiary, which statements reflect total assets of \$35,595 and \$33,400 as of December 31, 20X8 and 20X7, respectively, and total revenues of \$85,525 and \$73,497, respectively, for the years then ended. Those statements were audited by other auditors whose report has been

furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.

An example opinion paragraph for the previously described auditors' report follows:

In our opinion, based on our audits and the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the assets, liabilities, and stockholders' equity of ABC Company and subsidiaries as of December 31, 20X8 and 20X7, and their revenues and expenses and changes in stockholders' equity for the years then ended, on the basis of accounting described in Note A.

Change in Basis of Accounting. Companies sometimes change the basis of accounting used to present their financial statements from an OCBOA to GAAP, from GAAP to an OCBOA, or from one OCBOA to another. SAS No. 62 (AU 623.31, footnote 35) states that a change in basis of accounting from GAAP to an OCBOA does not require auditors to add an explanatory paragraph to their report because of the inconsistent application of accounting principles. (Thus, it implies that a change in basis of accounting is not a change in accounting principle as defined in SFAS No. 154, *Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3* (FASB ASC 250-10-20). That view is consistent with the one expressed in Technical Practice Aid TIS 9030.10.) The SAS recognizes, however, that some auditors may wish to add a paragraph highlighting the change in basis and allows them to do so. Such a paragraph also may disclose that another report has been issued on the company's financial statements prepared in conformity with another basis of accounting (such as when GAAP financial statements are issued in addition to cash basis financial statements). The following illustrates an explanatory paragraph that may be added to the audit report to emphasize a change in the basis of accounting:

As discussed in Note X to the financial statements, the 20X6 financial statements have been restated to conform to the income tax basis of accounting adopted in 20X7 and described in Note A.

Reporting When the Statement of Cash Flows Is Omitted. A statement of cash flows is not required in cash, modified cash, or income tax basis presentations. Therefore, an audit report on OCBOA financial statements would not need to be modified if the cash flow statement were omitted from the presentation. (If an entity chooses to present a statement of cash flows with its OCBOA financial statements, however, that statement should be reported on as a basic financial statement rather than as supplementary information.)

Reporting on Supplementary Information

When auditors submit a document containing audited financial statements to their clients or others, they have a responsibility to report on all the information in the document. Therefore, an auditors' report must disclose the responsibility assumed for the information outside the basic financial statements when it is included in an auditor-submitted document. The report should identify the additional information by using a descriptive title or indicating the page number of the document where the additional information is presented. The report also should state that the additional information is presented for purposes of additional analysis and is not a required part of the basic financial statements. In addition, the report should include the auditors' opinion on whether the additional information is stated fairly in all material respects in relation to the basic financial statements taken as a whole or a disclaimer of opinion, depending on whether the information has been subjected to auditing procedures applied in the audit of the basic financial statements. Auditors may express an opinion on a portion of the accompanying information and disclaim an opinion on the remainder.

Reporting in Accordance with International Standards

An auditing interpretation of AU 508 at AU 9508.56–.59 provides guidance for reports on audits conducted in accordance with U.S. generally accepted auditing standards and in accordance with International Standards on Auditing (ISAs). The interpretation indicates that if an auditor conducts the audit in accordance with U.S. GAAS and in accordance with ISAs promulgated by the International Auditing and Assurance Standards Board, in their entirety, the auditor's report may so indicate. In that type of engagement, auditors should comply with U.S. reporting standards. Additional clarifying guidance can be found in an interpretation to AU 534 at AU 9534.09–.11, *Financial Statements Audited in Accordance With International Standards on Auditing*.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

31. Robin is hired to audit a company's income tax basis financial statements. She is satisfied with the financial statements as a whole, except for an inconsistency in how the company applied accounting principles. How should Robin modify the auditors' report for this concern?
 - a. By adding additional explanatory language.
 - b. By disclaimer of opinion.
 - c. As an adverse opinion.
 - d. As a qualified opinion.
32. Hank is hired to audit a company's income tax basis financial statements. The company's financial statements fail to include an income tax provision, which has a material effect on the financial statements; and Hank expresses a qualified opinion. What other change to his auditors' report would be appropriate?
 - a. Expression of a qualified opinion is the only change required.
 - b. An explanatory paragraph must be added that says the statements are not presented fairly in all material respects.
 - c. An explanatory paragraph must be added that says, except for the effects of the departure, the statements are presented fairly in all material respects.
 - d. An explanatory paragraph must be added to disclose the reasons for the modification and their effects.
33. Lauren is hired to audit a company's financial statements that are prepared on the income tax basis of accounting. During the audit, doubt surfaces as to the company's ability to continue as a going concern. How should Lauren address this doubt in her auditors' report?
 - a. Lauren would only need to address this issue in the auditors' report if the financial statements had been prepared under GAAP.
 - b. Lauren must present the doubts in an explanatory paragraph that follows the opinion paragraph of her auditors' report.
 - c. Lauren must present a qualified or an adverse opinion, depending on how pervasive the doubt is and how well it was reflected in the financial statements.
34. During his audit of a company's income tax basis financial statements, George realizes that he must express a qualified opinion on the prior-year's financial statements. When reported on in the previous year, these financial statements received an unqualified opinion. What information should George include about this opinion change in an explanatory note in his auditors' report?
 - a. How the updated opinion relates to this year's financial statements.
 - b. The fact that the prior-year's statements received an unqualified opinion.
 - c. The date of the auditors' report on this year's income tax basis financial statements.
 - d. An in-depth description of the circumstances that led to the original opinion.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

31. Robin is hired to audit a company's income tax basis financial statements. She is satisfied with the financial statements as a whole, except for an inconsistency in how the company applied accounting principles. How should Robin modify the auditors' report for this concern? **(Page 80)**
- a. **By adding additional explanatory language. [This answer is correct. For the inconsistency described above, Robin could give an unqualified opinion if additional explanatory language is added to the standard auditors' report.]**
 - b. By disclaimer of opinion. [This answer is incorrect. Auditors generally issue a disclaimer of opinion when a scope limitation is so significant that a qualified opinion is not appropriate.]
 - c. As an adverse opinion. [This answer is incorrect. This opinion would only be given if an auditor believes departures from the basis of accounting are so material or pervasive that the financial statements are not fairly presented.]
 - d. As a qualified opinion. [This answer is incorrect. Qualified opinions are issued when there is a material departure from the basis of accounting or the scope of the audit is affected by conditions that do not allow auditors to apply necessary audit procedures.]
32. Hank is hired to audit a company's income tax basis financial statements. The company's financial statements fail to include an income tax provision, which has a material effect on the financial statements; and Hank expresses a qualified opinion. What other change to his auditors' report would be appropriate? **(Page 82)**
- a. Expression of a qualified opinion is the only change required. [This answer is incorrect. Other changes are needed if Hank expresses a qualified opinion for a departure from the income tax basis of accounting.]
 - b. An explanatory paragraph must be added that says the statements are not presented fairly in all material respects. [This answer is incorrect. This information would only need to be added to the report if Hank had expressed an adverse opinion.]
 - c. An explanatory paragraph must be added that says, except for the effects of the departure, the statements are presented fairly in all material respects. [This answer is incorrect. This information should be added to the opinion paragraph, not as an explanatory paragraph.]
 - d. **An explanatory paragraph must be added to disclose the reasons for the modification and their effects. [This answer is correct. If the effects are not reasonably determinable, Hank can state that fact in the explanatory paragraph instead.]**
33. Lauren is hired to audit a company's financial statements that are prepared on the income tax basis of accounting. During the audit, doubt surfaces as to the company's ability to continue as a going concern. How should Lauren address this doubt in her auditors' report? **(Page 83)**
- a. Lauren would only need to address this issue in the auditors' report if the financial statements had been prepared under GAAP. [This answer is incorrect. Under SAS No. 59, auditors have a responsibility to evaluate if there is a substantial doubt about the entity's ability to continue as a going concern. This responsibility applies to any audit, whether it is performed under GAAP or an OCBOA, such as the income tax basis.]
 - b. **Lauren must present the doubts in an explanatory paragraph that follows the opinion paragraph of her auditors' report. [This answer is correct. Information that could be in the explanatory paragraph includes (1) that the statements were prepared as if the entity would continue as a going concern, (2) reason why the entity might not be able to continue as a going concern, (3) management's plans**

regarding such matters, and (4) any adjustments in the financial statements that might result from the outcome of the uncertainty or the lack of such adjustments.]

- c. Lauren must present a qualified or an adverse opinion, depending on how pervasive the doubt is and how well it was reflected in the financial statements. [This answer is incorrect. A going concern uncertainty does not require a qualified or an adverse opinion.]
34. During his audit of a company's income tax basis financial statements, George realizes that he must express a qualified opinion on the prior-year's financial statements. When reported on in the previous year, these financial statements received an unqualified opinion. What information should George include about this opinion change in an explanatory note in his auditors' report? **(Page 83)**
- a. How the updated opinion relates to this year's financial statements. [This answer is incorrect. George must include, however, the fact that the auditor's updated opinion on the prior-year's statements is different from the previous opinion on those statements.]
 - b. The fact that the prior-year's statements received an unqualified opinion. [This answer is correct. George must include the type of opinion that was previously expressed in the explanatory note.]**
 - c. The date of the auditors' report on this year's income tax basis financial statements. [This answer is incorrect. However, George must include the date of the previous auditor's report in the explanatory note.]
 - d. An in-depth description of the circumstances that led to the original opinion. [This answer is incorrect. However, George must include the circumstances and events causing the change in opinion from unqualified to qualified.]

OTHER REPORTING SITUATIONS

Reporting on Regulatory Basis Financial Statements

SAS No. 62 defines the accounting basis that a reporting entity uses to comply with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject as an OCBOA. When reporting on financial statements that are prepared in conformity with such a regulatory basis, the appropriate form of report depends on the use of the report. SAS No. 62 (AU 623.05) allows auditors to report on regulatory basis financial statements as OCBOA financial statements if the statements and report are intended to be used solely by parties within the entity and by one or more regulatory agencies. Otherwise, the auditors' report should be modified (i.e., an "except for" or adverse opinion) for any material GAAP departures relating to the regulatory basis. For example, if regulatory basis financial statements of a nonprofit organization are also intended to be distributed to potential donors, the auditors' report should be modified for the GAAP departures.

Intended Solely for Regulatory Filing. As previously noted, if regulatory basis financial statements are intended to be used solely by parties within the entity and by one or more regulatory agencies, the auditor can report on them as OCBOA financial statements. However, SAS No. 62 (AU 623.05) states that a paragraph restricting use of the report to those within the company and one or more regulatory agencies should be added. For example, the following report, which is from SOP 95-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises*, as amended by SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*, is appropriate when reporting on audited financial statements prepared in conformity with statutory accounting practices used by an insurance company to comply with the requirements or financial reporting provisions of a government regulatory agency to whose jurisdiction the company is subject:

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
XYZ Insurance Company
City, State

We have audited the accompanying statutory statement of admitted assets, liabilities, and surplus of XYZ Insurance Company (a Texas corporation) as of December 31, 20X7, and the related statutory statements of income and changes in surplus, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. 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 of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described more fully in Note X to the financial statements, these financial statements were prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of [State of Domicile], which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of XYZ Insurance Company as of December 31, 20X7, and the results of its operations and its cash flows for the year then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the board of directors and management of XYZ Insurance Company and state insurance departments to whose jurisdiction the company is subject and is not intended to be and should not be used by anyone other than these specified parties.

Firm's signature

February 15, 20X8

The preceding report includes the standard introductory and scope paragraphs that identify the financial statements audited and state that the audit was made in accordance with auditing standards generally accepted in the United States of America. The explanatory paragraph states the basis of presentation, indicating that it is an OCBOA, and refers to the note to the financial statements that describes the basis. The opinion paragraph expresses the auditors' opinion about whether the financial statements are presented in conformity with the prescribed basis of accounting. If the auditors conclude that the financial statements are not presented fairly on the prescribed basis, they should disclose their reasons for that conclusion in an additional explanatory paragraph preceding the opinion paragraph and include appropriate modifying language and a reference to the explanatory paragraph in the opinion paragraph of their report. In addition, the report includes a restricted use paragraph (which is appropriate even though the auditor's report may, by law or regulation, become a matter of public record).

Not Limited to Use in Regulatory Filings. SAS No. 1 (AU 544) and Interpretation 15 of AU 623, *Auditor Reports on Regulatory Accounting or Presentation When the Regulated Entity Distributes the Financial Statements to Parties Other Than the Regulatory Agency Either Voluntarily or Upon Specific Request*, provide guidance on the form of reporting for financial statements prepared on a basis of accounting prescribed by a regulatory agency when the financial statements will not be limited to use in regulatory filings. AU 544 states that when the regulatory basis contains departures from GAAP, the auditors' report should be the standard form of report prescribed by SAS No. 58 (AU 508), modified (i.e., an "except for" or adverse opinion) because of the prescribed GAAP departures. The report also may include an additional paragraph that expresses an opinion on whether the financial statements are in conformity with the prescribed basis of accounting. Similarly, Interpretation 15 confirms that this type of reporting should be used when:

- a. the financial statements and report are intended for use by parties other than those within the entity and one or more regulatory agencies to whose jurisdiction the entity is subject, or
- b. the financial statements and report are distributed (either voluntarily or upon specific request) by the entity to parties other than the regulatory agencies to whose jurisdiction the entity is subject.

Although Interpretation 15 applies to all regulated entities, the interpretation specifically mentions certain state and local governmental entities that prepare financial statements under the requirements of a governmental regulatory agency.

AICPA Audit and Accounting Guide, Property and Liability Insurance, paragraph 8.21, (the AICPA Insurance Guide) begins a discussion which provides similar guidance on the form of report when auditors are requested to report on an insurance company's financial statements that are prepared in conformity with the basis of accounting used to comply with requirements of a regulatory agency and that are not limited to use in regulatory filings. The following illustrate the third, fourth, and fifth paragraphs in the report:

As described more fully in Note X to the financial statements, the Company prepared these financial statements using accounting practices prescribed or permitted by the Insurance Department of the State of [State of Domicile], which practices differ from generally accepted accounting principles. The effects on the financial statements of the variances between statutory accounting practices and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of XYZ Insurance Company as of December 31, 20X7, or the results of its operations or its cash flows for the year then ended.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of XYZ Insurance Company as of December 31, 20X7, and

the results of its operations and its cash flows for the year then ended, on the basis of accounting described in Note X.

When an adverse opinion is issued, SAS No. 58 (AU 508.59) states that auditors should disclose the dollar effect of the subject matter on the company's financial position, results of operations, and cash flows in a separate paragraph of their report, if reasonably determinable. As allowed by SAS No. 1 (AU 544.04), the last paragraph expresses an unqualified opinion on the presentation of the financial statements in accordance with the regulatory basis of accounting. However, the report does not include a restricted use paragraph.

Considerations for Compilations and Reviews. Unlike SAS No. 62, which provides specific guidance for reporting on audited regulatory basis financial statements, SSARS No. 1 does not provide specific guidance for reporting on compiled or reviewed regulatory basis financial statements. In addition, SSARS No. 1, (AR 100.17 and AR 100.50), makes no distinction in the reporting requirements for cash, tax, or regulatory basis financial statements.

IRS Form 990

Audits. Some states allow charitable organizations to use IRS Form 990, "Return of Organizations Exempt from Income Tax," as a uniform annual report for reporting to both state and federal governments, and some of those states require Form 990 to be accompanied by an auditors' report on the financial statements included in the form. SAS No. 1 (AU 544) and SAS No. 62 (AU 623), as well as an AICPA auditing interpretation at AU 9623.47–.53, state that the appropriate audit report for the financial statements included in Form 990 depends on (a) whether the financial statements presented in Form 990 are in conformity with GAAP and (b) the report's intended use.

If the financial statements included in Form 990 are in conformity with GAAP (including appropriate note disclosures), auditors should issue the form of report prescribed by SAS No. 58 (AU 508) with an unqualified opinion. However, financial statements included in Form 990 often contain certain departures from GAAP for such organizations. In those situations, the appropriate form of report is determined by the intended use of the report. In most states, the report is used solely to satisfy regulatory requirements, although the regulatory authorities make the financial statements and audit report a matter of public record. In some situations, however, Form 990 will be used for purposes other than regulatory filings.

When financial statements presented on Form 990 contain GAAP departures required by a state agency, the report form for a regulatory basis of accounting is appropriate only if the financial statements are intended to be used solely by parties within the entity and one or more regulatory agencies (including those situations in which, by law or regulation, the report may be made a matter of public record). The following is an example of such a regulatory basis report, based on the example report in the auditing interpretation at AU 9623.52.

INDEPENDENT AUDITOR'S REPORT

To ABC Charitable Organization
City, State

We have audited the balance sheet (Part IV) of ABC Charitable Organization (a nonprofit organization) as of December 31, 20X7, and the related statement of revenue, expenses, and changes in net assets (Part I) and the statement of functional expenses (Part II) for the year then ended included in the accompanying Internal Revenue Service Form 990. These financial statements are the responsibility of the Organization's management. 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 of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note A, these financial statements were prepared in conformity with the accounting practices prescribed by the Internal Revenue Service and the XYZ Office of the State of XX, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities, and net assets of ABC Charitable Organization as of December 31, 20X7, and its revenue, and expenses, and changes in net assets for the year then ended, on the basis of accounting described in Note A.

Our audit was made for the purpose of forming an opinion on the financial statements referred to in the first paragraph taken as a whole. The accompanying information on pages YY to ZZ is presented for purposes of additional analysis and is not a required part of the above financial statements. Such information, except for the portion marked "unaudited," on which we express no opinion, has been subjected to the auditing procedures applied in the audit of the financial statements referred to above; and in our opinion, the information is fairly stated in all material respects in relation to the above financial statements taken as a whole.

This report is intended solely for the information and use of the board of directors and management of ABC Charitable Organization, the Internal Revenue Service, and the XYZ Office of the State of XX and is not intended to be and should not be used by anyone other than these specified parties.

Firm's signature

February 15, 20X8

If Form 990 will be used for purposes other than regulatory filings (for example, copies of Form 990 are distributed to contributors or others), the regulatory basis report form is not appropriate. In those cases, auditors should express a qualified or adverse opinion on the financial statements if they are not in conformity with GAAP and, if reasonably determinable, disclose the effects of the GAAP departures on the financial statements. Otherwise, the report should state the effects are not reasonably determinable. The auditing interpretation at AU 9623.47–.53 does not discuss whether auditors may add a paragraph expressing an opinion on conformity with the accounting principles prescribed by the regulatory basis.

Can Form 990 Financial Statements Be Reported on as Tax Basis Financial Statements? Interpretation 14 of SAS No. 62 provides examples of nonprofit entities using the accounting principles followed in filing Form 990, thus acknowledging that such entities may issue tax basis financial statements based on financial information included in Form 990.

Reporting on the Other Information in Form 990. When reporting on the financial statements included in Form 990, auditors should note that the example report only expresses an opinion on three parts of the form: (a) the balance sheet (Part X); (b) the statement of revenue (Part VII); and (c) the statement of functional expenses (Part IX). The example report specifies that "the accompanying information on pages YY to ZZ is presented for purposes of additional analysis and is not a required part of the above financial statements." The report also adds that such information "has been subjected to the auditing procedures applied in the audit of the financial statements referred to above," except for the portion marked "unaudited," on which no opinion is expressed.

Considerations for Compilations and Reviews. Interpretation 10 of SSARS No. 1 (AR 9100.31–.32) indicates that information returns, such as Form 990, are considered tax returns for purposes of SSARS No. 1. Although SSARS No. 1 (AR 100.04) does not require reporting on financial presentations included in tax returns, accountants must apply the requirements of SSARS No. 1 to financial statements prepared on an income tax basis based on the tax return.

If the client requests the accountants to issue a compilation or review report on financial information included in Form 990, Interpretation 10 of SSARS No. 1 states that accountants may agree to issue such a report (upon compliance with applicable performance and reporting standards). However, the Form 990 should not be referred to in the accountants' report as a financial statement.

Other Definite Sets of Criteria Having Substantial Support

For audit engagements, SAS No. 62 (AU 623.04) includes “a definite set of criteria having substantial support that is applied to all material items appearing in financial statements” as one type of OCBOA. However, SAS No. 62 does not illustrate an auditors’ report on financial statements prepared in accordance with that type of OCBOA. Furthermore, the price-level basis of accounting (which is described in SOP 93-3, *Rescission of Accounting Principles Board Statements*) (FASB ASC 255-10) is the only OCBOA of that type explicitly mentioned in SAS No. 62. For compilation and review engagements, SSARS No. 1 (AR 100.04), as amended by SSARS No. 15, defines an OCBOA as “a definite set of criteria, other than GAAP, having substantial support underlying the preparation of financial statements prepared pursuant to that basis.” Unlike SAS No. 62, it does not mention the price-level basis of accounting. The following paragraphs discuss whether the fair value and liquidation bases of accounting should be reported on as OCBOAs.

Liquidation Accounting. The liquidation basis of accounting is GAAP when it is used by a company in liquidation or for which liquidation appears imminent. However, best practices indicate that the liquidation basis of accounting is an OCBOA and should be reported on accordingly in compilation, review, or audit engagements.

Prescribed Forms

Accountants may be engaged to report on financial information presented in prescribed forms or schedules. Prescribed forms include any standard preprinted form designed or adopted by the entity to which it is to be submitted or filed. A common problem when reporting on financial information in prescribed forms is determining the basis of accounting. If the prescribed form does not specify a basis, the basis normally used by the company appears to be the most appropriate basis for preparing the financial information included in the form. For instance, a professional corporation that has adopted the cash basis of accounting used for income tax reporting should apply those same principles unless the form specifically requests otherwise. The following paragraphs discuss various reporting considerations for OCBOA financial statements included in prescribed forms.

Compilations. OCBOA financial statements may be included in a prescribed form that specifies a measurement principle not in conformity with the OCBOA or fails to request the disclosures required by the OCBOA. SSARS No. 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* (AR 300), provides an alternative standard compilation report when the prescribed form or related instructions call for a departure from the OCBOA. Unlike a SSARS No. 1 compilation report that should be modified for an OCBOA departure, the SSARS No. 3 alternative report does not enumerate departures required by the prescribed form. Based on the presumption that the information required by a prescribed form is sufficient to meet the needs of the entity that designed or adopted it, there is no need for that entity to be advised of departures from the accounting basis required by the form or related instructions. However, application of SSARS No. 3 to financial statements prepared on an OCBOA is sometimes difficult because many prescribed forms presume accrual basis financial statements and do not request disclosure of use of an OCBOA. The SSARS No. 3 compilation report on OCBOA statements must disclose—

- a. that the statements are presented in accordance with requirements of the prescribing body and
- b. that those requirements differ from the OCBOA being used.

In addition, footnote 1 of SSARS No. 3 (AR 300.01) requires disclosing the basis being used. That information may be provided either in a note on the face of the financial statements, in an attached note, or in the accountants’ report. The following report on cash basis financial statements illustrates disclosure in the report:

I (We) have compiled the statement of assets, liabilities, and equity—cash basis of XYZ Company, Inc. as of December 31, 20X7, and the related statement of revenues and expenses—cash basis for the year then ended included in the accompanying prescribed form. Our compilation was in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The financial statements have been prepared on the cash basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.

My (Our) compilation was limited to presenting in the form prescribed by the Texas Department of Highways information that is the representation of management (the owners). I (We) have not audited or reviewed the financial statements referred to above and, accordingly, do not express an opinion or any other form of assurance on them.

These financial statements (including related disclosures) are presented in accordance with the requirements of the Texas Department of Highways, which differ from the cash basis of accounting. Accordingly, these financial statements are not designed for those who are not informed about such differences.

Firm's signature

February 15, 20X8

As a practical matter, some accountants believe that, in the situation illustrated, the statement titles modified to say cash basis are sufficient notification, and that a sentence such as the last one of the first paragraph in the preceding report is not required. That is because SSARS No. 3 only requires disclosing the OCBOA and does not require describing it or even saying that it is a comprehensive basis of accounting other than GAAP.

Applying SSARS No. 3 to OCBOA statements requires judgment. For example, when compiling a cash basis statement of assets and liabilities for a professional corporation for inclusion in a prescribed form that provides a line for accounts receivable, the following reporting situations may occur:

- a. If the cash basis company maintains a memo record of its accounts receivable, the company may decide to provide the information. If recording the receivable does not in reality create accrual basis statements, the accountants should issue a SSARS No. 3 report that includes the OCBOA disclosure. Completing the accounts receivable line is a departure from the cash basis but is required by the form and, thus, does not require disclosure in the report.
- b. In the previous circumstance, if the statements are now essentially accrual basis statements, the accountants must then determine whether the preprinted form calls for a departure from GAAP. If so, SSARS No. 3 is applicable. If the form does not call for a departure from GAAP, SSARS No. 1 is applicable. In either event, reference to the cash basis is not appropriate.
- c. The company may have accounts receivable but decide to leave the accounts receivable line on the form blank. In that situation, the accountants could issue a SSARS No. 3 report that includes the OCBOA disclosure, and that discloses the departure from the requirements of the form (i.e., accounts receivable not presented).

OCBOA departures, other than those specified by the form or related instructions, should be treated as any OCBOA departure. In that instance, the sentence preceding the separate report paragraph disclosing the OCBOA departure might state, "However, I (we) did become aware of a departure from the cash basis that is not called for by the prescribed form or related instructions, as described in the following paragraph."

Reviews. A review can be performed on OCBOA financial statements included in a prescribed form, but SSARS No. 3 reporting standards would not apply. (That view is supported by an AICPA Technical Practice Aid at TIS 9150.10.) SSARS No. 3 provides an alternative standard compilation report for financial statements included in certain prescribed forms. However, SSARS No. 3 makes no provision for an alternative review report on such financial statements. Therefore, a review report must conform to the standards of SSARS No. 1. For OCBOA financial statements, that means the report must describe any departures from the OCBOA (even if the departures are called for by the form). The report also must include the effects of the departure, if known, or include a statement that the effects have not been determined.

Audits. Auditors may be engaged to report on OCBOA financial information presented in prescribed forms or schedules. However, such forms often prescribe wording for the auditors' report that is unacceptable to auditors because it does not conform to applicable professional reporting standards. For example, the prescribed language of the report may call for assertions by the auditors that are not consistent with their function or responsibility. SAS

No. 62 (AU 623.33) states that some report forms may be made acceptable by inserting wording, while others may be made acceptable only by complete revision. When a prescribed form calls on auditors to make an assertion that they believe they are not justified in making, they should reword the form or attach a separate report.

Titles. Unmodified titles such as “Balance Sheet” and “Statement of Income” generally are not suitable for OCBOA financial statements. Therefore, in some situations it may be appropriate for the accountants to alter the titles on a prescribed form to conform to appropriate statement titles. In that case, the accountants’ or auditors’ report should refer to the altered titles as they appear on the prescribed form. In practice, however, the titles on the form usually are not changed, and the accountants’ or auditors’ report on the statements uses the preprinted titles.

Personal Financial Statements

CPAs are frequently asked to provide services in connection with personal financial statements prepared for use in obtaining credit, for income tax planning, retirement planning, or gift and estate planning purposes, or for public disclosure by candidates for public office. The term *personal financial statements* refers to financial statements that present the personal assets and liabilities of an individual or group of related individuals (a family). The term does not include financial statements presenting the financial position or results of operations of unincorporated business enterprises such as proprietorships or partnerships.

Personal financial statements may be prepared on one of the following bases:

- a. *Cash Basis.* Using the *pure* cash basis, the only asset reflected on the financial statement is cash, no liabilities, and only cash receipts and disbursements are reported as increases and decreases in net assets.
- b. *Modified Cash Basis.* Under the modified cash basis, the pure cash basis is modified to report certain assets and liabilities, generally at the amounts that would be reported under either the historical cost basis or the current value basis.
- c. *Historical Cost Basis.* The historical cost basis generally measures the individual’s assets and liabilities in accordance with GAAP for reporting entities other than individuals.
- d. *Income Tax Basis.* Assets and liabilities under the income tax basis are measured in accordance with the principles the individual uses for federal or other income tax reporting.

The following paragraphs provide guidance for reporting on compiled or reviewed personal financial statements prepared using a comprehensive basis of accounting other than GAAP. *PPC’s Guide to Auditor’s Reports* discusses reporting on audits of personal financial statements prepared in accordance with an other comprehensive basis of accounting.

Compilation and Review Reports. Compilations and reviews of personal financial statements prepared in conformity with an other comprehensive basis of accounting, like other such engagements, are subject to both the performance and reporting requirements of SSARS No. 1. (*PPC’s Guide to Compilation and Review Engagements* provides detailed guidance on performing and reporting on compilations and reviews of personal financial statements.)

The form and substance of a compilation or review report issued in connection with personal financial statements prepared on an other comprehensive basis of accounting should not differ from such reports issued for commercial entities. Nevertheless, subtle differences in wording are caused by the nature of the engagement. For instance, the financial statement titles in reports on personal financial statements would typically be different [e.g., “Statement of Assets and Liabilities—Income Tax (Historical Cost) Basis” and, if presented, “Statement of Changes in Net Assets—Income Tax (Historical Cost) Basis”]. In addition, SOP 82-1, *Accounting and Financial Reporting for Personal Financial Statements* (FASB ASC 274-10), discusses identifying the individuals (rather than the company) about whom the financial statements are prepared, as well as noting that the representations are those of the individuals instead of management of a company. Finally, the AICPA *Personal Financial Statements Guide* recommends noting, in a review engagement, that the inquiries were made of the individuals and not management.

Compiled Personal Financial Statements That Omit Substantially All Disclosures. SSARS No. 1 (AR 100.19–.22) allows accountants to issue a compilation report on financial statements that omit substantially all

disclosures by adding a third paragraph to the standard compilation report. That option is available also for personal financial statements. When personal financial statements omit substantially all disclosures and do not disclose the basis of accounting used to prepare the financial statements, accountants should include a sentence such as the following at the end of the first paragraph of their compilation report:

The financial statements have been prepared on the historical cost basis of accounting (or the accounting basis used by the individuals for income tax purposes), which is a comprehensive basis of accounting other than generally accepted accounting principles.

Personal Financial Statements Included in Written Personal Financial Plans. SSARS No. 6, *Reporting on Personal Financial Statements Included in Written Personal Financial Plans* (AR 600.03), provides an exemption from both the performance and reporting standards of SSARS No. 1 for personal financial statements included in written personal financial plans provided both of the following conditions are met:

- The accountant establishes an understanding with the client, preferably in writing, that the financial statements (a) will be used solely to assist the client and the client's advisers to develop the client's personal financial goals and objectives and (b) will not be used to obtain credit or for any purposes other than developing the financial plan.
- Nothing comes to the accountant's attention during the engagement that would cause the accountant to believe that the financial statements will be used to obtain credit or for any purposes other than developing the client's financial goals and objectives.

When both of those conditions are met, accountants may add language such as the following to the written personal financial plan:

The accompanying statement of assets and liabilities—income tax basis of John and Jane Doe, as of December 31, 20XX, was prepared solely to help you develop your personal financial plan. Accordingly, it may be incomplete or contain other departures from the income tax basis of accounting and should not be used to obtain credit or for any purposes other than developing your financial plan. We have not audited, reviewed, or compiled the statement.

Personal Financial Statements Intended for Client Use Only. When accountants are engaged to compile personal financial statements, it is usually because of a request for compiled statements by a third party user, such as a banker or other lender. Other situations may arise in which accountants are engaged to provide other services for a client, and personal financial statements are prepared in connection with such other services. For instance, accountants engaged to prepare a client's tax return might find that they must prepare the client's personal financial statements before preparing their return. In any event, if accountants submit financial statements to the client, SSARS No. 1 requires them to compile the statements. Whether they also are required to issue a compilation report on the statements depends upon the expected use of the statements. If the statements are expected to be used by third parties, accountants are required to issue a SSARS No. 1 compilation report. If the statements are not expected to be used by third parties (i.e., if the statements are intended for the client's use only), accountants can issue an engagement letter in lieu of a compilation report as allowed by SSARS No. 1.

Accordingly, if the financial statements are to be used by both the client and his or her advisers, accountants who choose to not follow SSARS No. 6 will be required to compile the statements and issue a compilation report in accordance with SSARS No. 1. Accountants have followed the guidance in SSARS No. 6 since it was first issued in 1986 without reporting any practice problems. In addition, SSARS No. 6 exempts accountants from the performance standards of SSARS No. 1, so it is easier to apply than that standard.

Specified Elements, Accounts, or Items of a Financial Statement

Authoritative guidance for reporting on specified elements, accounts, or items of a financial statement is contained in SAS No. 62 (AU 623), *Special Reports*, SSAE No. 10, *Attestation Standards: Revision and Recodification*, and SSARS No. 13 (AR 110), *Compilation of Specified Elements, Accounts, or Items of a Financial Statement*. According to SAS No. 62, an accountant can audit a specified element of a financial statement that is presented separately, i.e., not presented with financial statements as supplementary information. The accountant may also review such

information under the auditing of attestation standards. Agreed-upon procedures may also be applied. Detailed information on reporting on a specified element, account, or item of a financial statement under the auditing or attestation standards can be found in *PPC's Guide to Auditor's Reports* and *PPC's Guide to Nontraditional Engagements*. To order, visit **ppc.thomsonreuters.com** or call (800) 323-8724.

In addition to the above alternatives, the accountant can issue a compilation report on a presentation of one or more specified elements, accounts, or items of a financial statement following the guidance in SSARS No. 13. When the accountant is engaged to compile or issues a compilation report on one or more specified elements, accounts, or items of a financial statement, the report should state that:

- a. The specified elements, accounts, or items identified in the report were compiled. If the compilation was performed in conjunction with a compilation of the company's financial statements, the paragraph should so state and indicate the date of the accountant's compilation report on those financial statements. In addition, any departure from the standard report on those statements should be disclosed if considered relevant to the presentation of the specified elements, accounts, or items.
- b. The compilation has been performed in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
- c. The compilation is limited to presenting financial information that is the representation of management (owners).
- d. The specified elements, accounts, or items have not been audited or reviewed and, accordingly, the accountant does not express an opinion or any other form of assurance on them.

The report should also describe the basis of accounting on which the specified elements, accounts, or items are presented if that basis is not GAAP and state that the basis of presentation is a comprehensive basis of accounting other than generally accepted accounting principles.

In addition, SSARS No. 13 requires that the report include:

- a. A signature of the accounting firm or the accountant. The signature can be manual, stamped, electronic, or typed.
- b. The date of the compilation report. The date of the accountant's report should be the date of completion of the compilation procedures.

Each page of the compiled specified elements, accounts, or items of a financial statement should refer to the accountant's compilation report and notes to the presentation. Finally, the report should not describe any other procedures that the accountant might have performed before or during the engagement.

An accountant engaged to compile one or more specified elements, accounts, or items of a financial statement is required to report on such compiled financial information. However, an accountant who has not been so engaged is not required to report, as SSARS No. 13 does not preclude the accountant from preparing or assisting in the preparation of one or more specified elements, accounts, or items of a financial statement without issuance of a report. But, if the accountant prepares or assists a client in preparing a schedule of one or more specified elements, accounts, or items of a financial statement, the accountant should consider the potential of being associated with the schedule and the likelihood that the user may inappropriately infer, through association, an unintended level of assurance. An accountant could be associated with the schedule because his or her name is somehow included in a document containing the schedule or through verbal communication. Exhibit 2-5 summarizes the reporting choices available when associated with (or asked to report on) a specified element, account, or item of a financial statement. (The accountant may also choose to issue a disclaimer on such information.)

Exhibit 2-5**Reporting on a Specified Element**

Assurance Level	Element Presented Separately	Element Presented as Supplement to Financial Statements
Audit	May audit under SAS No. 62 (AU 623), <i>Special Reports</i> .	May subject the element to auditing procedures applied in the audit of the financial statements and report under SAS No. 29 (AU 551), <i>Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents</i> (if an auditor-submitted document).
Review or agreed upon procedures	May review or apply agreed-upon procedures under SSAE No. 10, <i>Attestation Standards, Revision and Recodification</i> .	May subject the element to the inquiry and analytical procedures applied in the review of the financial statements and report under SSARS No. 1 (AR 100.83).
Compilation	May compile under SSARS No. 13, <i>Compilation of Specified Elements, Accounts, or Items of a Financial Statement</i> .	May compile under SSARS No. 1 (AR 100.83).
	*	*

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

35. What basis of accounting is the liquidation basis of accounting when it is used by a company in liquidation or for which liquidation appears imminent?
- a. OCBOA.
 - b. GAAP.
36. Myrtle is compiling a cash basis statement of assets and liabilities for Throckmorton Associates for inclusion in a prescribed form that provides a line for accounts receivable. Throckmorton Associates is a cash basis company and maintains a memo record of its accounts receivable so decides to provide the information. How should Myrtle proceed if recording the receivable does not create accrual basis statements?
- a. Issue a SSARS No. 3 report that includes the OCBOA disclosure.
 - b. Determine if the preprinted form calls for departure from GAAP.
 - c. Issue a SSARS No. 3 report that includes OCBOA disclosure and discloses the departure from the requirements of the form.
37. In preparing personal financial statements, which of the following basis is measured in accordance with the principles the individual uses for federal income tax reporting?
- a. Modified cash basis.
 - b. Historical cost basis.
 - c. Cash basis.
 - d. Income tax basis.
38. SSARS No. 13 requires which of the following to be included in the report when reporting on specified elements, accounts, or items of a financial statement?
- a. Signature of the accounting firm and the accountant.
 - b. The date of the compilation report.
39. Which item below is required of an accountant when engaged to issue a compilation report on specified elements, accounts, or items of a financial statement?
- a. Describe in the report the basis of accounting on which specified items are presented if that basis is not GAAP.
 - b. Disclose any departures from the standard report on those statements regardless of relevancy.
 - c. Describe in the report any procedures that the accountant might have performed during the engagement.
 - d. Refer to the accountant's compilation report and notes to the presentation on specific pages of the compiled specified items of the financial statement.

40. When the accountant is engaged to compile or issues a compilation report on one or more specified elements, accounts, or items of a financial statement, the report should state that all of the following were performed **except**:
- a. The compilation was performed in accordance with GAAP.
 - b. The compilation only presents financial information that is the representation of the owners.
 - c. Departures from the standard report on the statements are disclosed.
 - d. The specified accounts and elements have not been audited and reviewed.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

35. What basis of accounting is the liquidation basis of accounting when it is used by a company in liquidation or for which liquidation appears imminent? **(Page 92)**
- a. OCBOA. [This answer is incorrect. Best practices indicated that the liquidation basis of accounting is an OCBOA when it is *not* used by a company in liquidation or for which liquidation appears imminent. In such cases it should be reported on accordingly in compilation, review, or audit engagements.]
 - b. **GAAP. [This answer is correct. The liquidation basis of accounting is GAAP when it is used by a company in liquidation or for which liquidation appears imminent.]**
36. Myrtle is compiling a cash basis statement of assets and liabilities for Throckmorton Associates for inclusion in a prescribed form that provides a line for accounts receivable. Throckmorton Associates is a cash basis company and maintains a memo record of its accounts receivable so decides to provide the information. How should Myrtle proceed if recording the receivable does not create accrual basis statements? **(Page 93)**
- a. **Issue a SSARS No. 3 report that includes the OCBOA disclosure. [This answer is correct. Since recording the receivable does not in reality create accrual basis statements, Myrtle should issue a SSARS No. 3 report that includes the OCBOA disclosure.]**
 - b. Determine if the preprinted form calls for departure from GAAP. [This answer is incorrect. If Throckmorton Associates' statements, after providing the accounts receivable information, were essentially accrual basis statements, Myrtle must then determine if the preprinted form calls for a departure from GAAP. If so, SSARS No. 3 is applicable. In this case, recording the receivable did not create accrual basis statements, so this answer does not apply.]
 - c. Issue a SSARS No. 3 report that includes OCBOA disclosure and discloses the departure from the requirements of the form. [This answer is incorrect. If Myrtle had decided to leave the accounts receivable line on the form blank, Myrtle could issue a SSARS No.3 report that includes the OCBOA disclosure and that discloses the departure from the requirements of the form.]
37. In preparing personal financial statements, which of the following basis is measured in accordance with the principles the individual uses for federal income tax reporting? **(Page 94)**
- a. Modified cash basis. [This answer is incorrect. Under the modified cash basis, the pure cash basis is modified to report certain assets and liabilities, generally at the amounts that would be reported under either historical cost basis or the current value basis.]
 - b. Historical cost basis. [This answer is incorrect. The historical cost basis generally measures the individual's assets and liabilities in accordance with GAAP for reporting entities other than individuals.]
 - c. Cash basis. [This answer is incorrect. Using the pure cash basis, the only asset reflected on the financial statement is cash, no liabilities, and only cash receipts and disbursements are reported as increases and decreases in net assets.]
 - d. **Income tax basis. [This answer is correct. Assets and liabilities under the income the income tax basis are measured in accordance with the principles the individual uses for federal or other income tax reporting.]**
38. SSARS No. 13 requires which of the following to be included in the report when reporting on specified elements, accounts, or items of a financial statement? **(Page 96)**
- a. Signature of the accounting firm and the accountant. [This answer is incorrect. SSARS No. 13 requires the report to include the signature of the accounting firm or the accountant; but not both.]

- b. The date of the compilation report. [This answer is correct. SSARS No. 13 requires the date of completion of the compilation procedures to be included in the report.]**
39. Which item below is required of an accountant when engaged to issue a compilation report on specified elements, accounts, or items of a financial statement? **(Page 96)**
- a. Describe in the report the basis of accounting on which specified items are presented if that basis is not GAAP. [This answer is correct. The report should describe the basis of accounting on which the specified elements, accounts, or items are presented if that basis is not GAAP and state that the basis of presentation is a comprehensive basis of accounting other than GAAP.]**
 - b. Disclose any departures from the standard report on those statements regardless of relevancy. [This answer is incorrect. Departures from the standard report which are relevant to the presentation of the specified elements, accounts, or items must be disclosed.]
 - c. Describe in the report any procedures that the accountant might have performed during the engagement. [This answer is incorrect. The report should not describe any other procedures that the accountant might have performed before or during the engagement.]
 - d. Refer to the accountant's compilation report and notes to the presentation on specific pages of the compiled specified items of the financial statement. [This answer is incorrect. Each page of the compiled specified accounts, elements, or items of a financial statement should refer to the accountant's compilation report and notes to the presentation.]
40. When the accountant is engaged to compile or issues a compilation report on one or more specified elements, accounts, or items of a financial statement, the report should state that all of the following were performed **except: (Page 96)**
- a. The compilation was performed in accordance with GAAP. [This answer is correct. An accountant who is engaged to compile or issues a compilation report on one or more specified elements, accounts, or items of a financial statement, the report should state that the compilation has been performed in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.]**
 - b. The compilation only presents financial information that is the representation of the owners. [This answer is incorrect. An accountant who is engaged to compile or issues a compilation report on one or more specified elements, accounts, or items of a financial statement, the report should state that the compilation is limited to presenting financial information that is the representation of management (owners).]
 - c. Departures from the standard report on the statements are disclosed. [This answer is incorrect. If the compilation was performed in conjunction with a compilation of the company's financial statements, the paragraph should so state and indicate the date of the accountant's compilation report on those financial statements. In addition, any departure from the standard report on those statements should be disclosed if considered relevant to the presentation of the specified elements, accounts, or items.]
 - d. The specified accounts and elements have not been audited and reviewed. [This answer is incorrect. An accountant who is engaged to compile or issues a compilation report on one or more specified elements, accounts, or items of a financial statement, the report should state that the specified elements, accounts, or items have not been audited or reviewed and, accordingly, the accountant does not express an opinion or any other form of assurance on them.]

EXAMINATION FOR CPE CREDIT**Lesson 2 (OFSTG091)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

21. Jason prepares an auditors' report for a C corporation using the income tax basis of accounting. In which of the following scenarios has he correctly followed one of the general reporting requirements?
- a. The title of the auditors' report is "ACCOUNTANTS' REPORT ON FINANCIAL STATEMENTS.
 - b. The report date is June 1, giving Jason until June 30 to finish obtaining sufficient audit evidence to support his opinion.
 - c. He refers to the statements in the report by the titles they would have had as GAAP statements.
 - d. The report is addressed to the corporation's board of directors.
22. Which of the following pieces of information would be stated in a compilation report?
- a. The financial statements were reviewed in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
 - b. The engagement consists principally of inquiries of company personnel and analytical procedures applied to financial data.
 - c. All of the information included in the financial statements is the representation of the management of the entity.
 - d. Do not select this answer choice.
23. Hannah is engaged to prepare a review report on financial statements prepared on an other comprehensive basis of accounting. Which of the following disclosures would be appropriate?
- a. Lack of independence.
 - b. Substantially all disclosures omitted.
 - c. Only selected information is disclosed.
 - d. The basis of accounting.
24. During the course of his review engagement, B.J. discovers that the company's income tax basis financial statements contain material measurement departures from the OCBOA. B.J. is able to conclude that the misstatement was an error, not an attempt to mislead the reader. Select the outcome that would be the most preferable in B.J.'s situation.
- a. B.J. withdraws from the review engagement immediately and consults legal counsel.
 - b. B.J. modifies the report to indicate that the financial statements are not presented fairly in conformity with the income tax basis and to indicate his adverse opinion.
 - c. B.J. reports on the nature and effects of the departures from the income tax basis of accounting in the review report.
 - d. B.J. convinces the company to revise the financial statements so they are in conformity with the income tax basis of accounting.

25. Leonard is engaged to review a company's financial statements. Another accountant, Sally, reviewed a portion of the financial statements of one of the company's subsidiaries. Leonard refers to Sally in the review report on the consolidated statements. Which of the following scenarios best reflects how Leonard should proceed?
- a. Leonard must review the portion of the financial statements Sally reviewed and issue a separate review report on them, as well.
 - b. Leonard must have Sally reissue her report and include it with his review report.
 - c. Leonard must indicate the magnitude of the portion of the financial statements Sally reviewed.
 - d. All Leonard must include is that another accountant was involved in the review.
26. Nora is reporting on comparative financial statements of a nonissuer that include statements of a prior-period, previously reported on by another accountant. Nora has several options regarding the report on the prior-period financial statements. Which of the following is **not** one of those options?
- a. Attempt to have the predecessor accountant reissue his or her report.
 - b. Report on the financial statements for both years.
 - c. Perform a compilation, audit, or review of the prior-period financial statements and issue her own report.
 - d. Make reference to the predecessor accountant's report in her own report.
27. Which of the following scenarios is appropriate for restricted-use compilation or review reports?
- a. Once the financial statements have been restricted and the engagement completed, other specified parties cannot be added.
 - b. As long as the report indicates that it is not intended for general use, the specified parties do not need to be identified in the report.
 - c. The accountant will be responsible for controlling the distribution of any restricted-use reports he or she produces.
 - d. An accountant is permitted to restrict the use of a report even if not required to do so by professional standards.
28. Which of the following must be stated in an auditors' report on OCBOA financial statements?
- a. Whether the statements are presented fairly with the income tax basis of accounting.
 - b. The financial statements are the responsibility of the auditor.
 - c. The difference between GAAP and the income tax basis.
 - d. That the auditors applied the procedures as required by management.
29. Match the following auditors' report modifications with the circumstance in which they would be appropriate.
- | | |
|--------------------------|---|
| 1. Qualified opinion | i. Going concern uncertainty |
| 2. Adverse opinion | ii. Measurement or disclosure departure from the income tax basis of accounting |
| 3. Disclaimer of opinion | iii. Pervasive departure from the income tax basis of accounting |

4. Unqualified opinion with required explanatory language
- iv. Auditors revise opinion on prior-period financial statements in comparative financial statements
 - v. Scope limitation
 - vi. Pervasive scope limitation
- a. 1., iv.; 2., ii. and iii.; 3., v. and vi.; 4., i.
- b. 1., iii. and vi.; 2., i. and iv.; 3., ii.; 4., v.
- c. 1.,vi.; 2., ii.; 3., i. and v.; 4., iii. and iv.
- d. 1., ii. and v.; 2., iii.; 3., vi.; 4., i. and iv.
30. Mel is hired to audit a company's financial statements prepared on the income tax basis of accounting. During the audit, he discovers that the company changed its policy for determining cash equivalents during the fiscal year. How will this affect Mel's auditors' report?
- a. Mel must refer to the change in an explanatory paragraph and in the opinion paragraph.
 - b. Mel must refer to the change in an explanatory paragraph only.
 - c. Mel must present a qualified opinion in the auditors' report.
 - d. Mel must present an adverse opinion in the auditors' report.
31. Thomson & Thompson (TNT) presents OCBOA financial statements. TNT presents a statement of cash flows, as well. How should the auditor deal with this situation?
- a. The auditor must request that TNT omit the statement of cash flows.
 - b. The auditor must request that TNT change its basis of accounting to GAAP.
 - c. The auditor must report on the statement of cash flows as supplementary information.
 - d. The auditor must report on the statement of cash flows as a basic financial statement.
32. When an auditors' opinion is based, in part, on the report of other auditors which of the following paragraphs of the auditor's report should disclose that information?
- a. Introductory and opinion paragraphs.
 - b. Opinion and scope paragraphs.
 - c. Separate explanatory paragraph.
 - d. Introductory and scope paragraphs.
33. According to SAS No. 58, when an adverse opinion is issued on the presentation of the financial statements in conformity with GAAP, the auditor should disclose the dollar effect of the subject matter on the company's financial position, cash flows, and results of operation in which of the following?
- a. The introductory paragraph of the report.
 - b. The opinion paragraph of the report.

- c. The scope paragraph of the report.
 - d. A separate paragraph of the report.
34. If the financial statements included in Form 990 are in conformity with GAAP, auditors should issue the form of report prescribed by SAS No. 58 with what type of opinion?
- a. Qualified.
 - b. Unqualified.
 - c. Adverse.
 - d. Disclaimer of an opinion.
35. Can Form 990 financial statements be reported on as tax basis financial statements?
- a. Yes.
 - b. No.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.
36. Which of the following bases of accounting is most appropriate when reporting on financial information in prescribed forms when the proscribed form does not specify a basis?
- a. Modified cash.
 - b. Cash.
 - c. Income tax.
 - d. The basis normally used by the company.
37. If a review is performed on OCBOA financial statements included in a prescribed form, which of the following Standards would **not** apply?
- a. SSARS No. 1.
 - b. SSARS No. 3.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.
38. Compilations and reviews of personal financial statements prepared in conformity with an OCBOA are subject to which of the following SSARS No. 1 requirements?
- a. Performance.
 - b. Reporting.
 - c. Performance and reporting.
 - d. Do not select this answer choice.

39. Which of the following appropriately describes personal financial statements?
- a. Financial statements presenting the personal assets and liabilities of an individual or group of related individuals.
 - b. Financial statements presenting the financial position or results of operations of unincorporated business enterprises such as partnerships.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.
40. Which of the following can happen when reporting on a specified element and the element is presented as a supplement to the financial statements and the assurance level is either reviewed or agreed upon procedures?
- a. May subject the element to the inquiry and analytical procedures applied in the review of the financial statements and report under SSARS No. 1.
 - b. May compile under SSARS No. 1.
 - c. May subject the element to auditing procedures applied in the audit of financial statements and report under SAS No. 29.
 - d. Do not select this answer choice.

GLOSSARY

Accrual Method of Accounting: Under the accrual method of accounting, income is reported in the tax year earned, whether or not received, and deductions are claimed in the tax year incurred, whether or not paid.

Adverse Opinion: An *overall* audit opinion that states that the financial statements do *not* present fairly the financial position or the results of operations or cash flows in conformity with generally accepted accounting principles (GAAP) or an other comprehensive basis of accounting (OCBOA). Auditors must have as much sufficient evidential matter to support an adverse opinion as for an unqualified opinion.

Audit: Technically defined, auditing is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events, determining the degree to which those assertions correspond to established criteria, and communicating the results of the audit to interested users. For financial statements, an audit is an examination of accounting records and other supporting evidence for the purpose of expressing an opinion about whether or not the financial statements fairly represent the financial position, operating results, changes in owners' (stockholders') equity, and cash flows in accordance with GAAP or an OCBOA.

C corporation: A corporation organized under subchapter C of the Internal Revenue Code. A C corporation pays an income tax on taxable income at the entity level.

Cash Method of Accounting: Under the cash method of accounting, income is reported in the tax year actually or constructively received and expenses are deducted in the tax year paid.

Compilation: Presenting, in the form of financial statements, information that is the representation of management (owners) without undertaking to express any assurance on the statements.

Consolidation: A reporting procedure in which the financial statements of the parent and the subsidiary are combined. The financial statements are prepared by the parent, not by the subsidiary. Consolidation is a reporting procedure only. It does not affect the accounting records of either the parent or the subsidiary.

Contingency: An event or condition that may occur in the future but that cannot currently be predicted. It has an uncertain outcome. The outcome of that event will change an existing condition or resolve a current uncertainty. A contingency is classified as probable (it is likely to happen), reasonably possible (it may happen, but the chance is neither likely nor remote), or remote (it is not apt to occur).

Disclaimer of Opinion: An expression of *no* opinion. The auditor does not express an opinion on the financial statements due to lack of independence or pervasive and massive deficiency of evidence or uncertainty.

Disclosure: Description of pertinent facts in a financial report.

Financial Statements: The principal means of communicating financial information to those users external to the entity. Financial statements are a formal tabulation of names and amounts of items derived from the accounting records by simplifying, condensing, and aggregating. They are a fundamentally related set of tabulations that articulate with each other and derive from the same underlying data. Financial statements are representations of the assertions of management. The fairness of their presentation in conformity with GAAP or an OCBOA is management's responsibility.

Generally Accepted Accounting Principles (GAAP): Basic accounting principles and standards and specific conventions, rules, and regulations that define accepted accounting practice at a particular time by incorporation of consensus and substantial authoritative support. To prepare financial statements for *other than governmental entities* in accordance with GAAP, the CPA must apply those principles found in sources of established accounting principles as described in SAS 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.

Income Tax Basis of Accounting: The basis of accounting an entity uses or expects to use to file its income tax return. The income tax basis of accounting is an OCBOA. Typically, it is based on federal income tax laws found in the Internal Revenue Code and related revenue rulings, regulations, and procedures.

Intangible Assets: Nonphysical assets (lacking physical substance) whose value derives from the rights that their ownership confers (e.g., goodwill). The evidence of existence of an intangible asset is elusive, value is often difficult to estimate, and useful life is often indeterminable.

Limited Liability Company (LLC): A form of business organization created by statute which is a separate legal entity from its owners and has attributes of both a *corporation* and a *partnership*. A principal benefit of the LLC format is *limited liability* for its members and managers, so that such persons are not personally liable for the debts and obligations of the entity, similar to a *corporation*. Another principal benefit of the LLC format, when properly formed and organized, is that the LLC does not incur tax liability at the entity level; it is a *pass-through entity*. The members of the LLC recognize the tax consequences, similar to a *partnership*.

More Likely Than Not: There is greater than a 50 percent chance.

Other Comprehensive Bases of Accounting (OCBOA): Financial records are maintained and reported according to a basis other than GAAP. A comprehensive basis of accounting other than GAAP is one of the following:

- A basis of accounting that the entity used to comply with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject (e.g., pursuant to the rules of a state insurance commission).
- A basis of accounting used to file income tax returns for the period covered by the financial statements.
- The cash receipts and disbursements basis of accounting, and modifications of the cash basis when such modifications are substantially supported, such as recording depreciation on fixed assets or accruing income taxes.
- A definite set of criteria having substantial support that is applied to all items appearing in financial statements, such as the price level basis of accounting.

Parent-company Financial Statements: A reporting entity's financial statements when they report as a parent company. They are not a valid substitute for consolidated financial statements.

Partnership: A form of business in which two or more persons join their money and skills in conducting the business as co-owners. Partnerships are treated as a conduit and are not subject to taxation. Various items of partnership income, expenses, gains, and losses flow through to the individual partners and are reported on their personal income tax returns.

Primary Beneficiary: An enterprise that consolidates a variable interest entity under the provisions of FIN 46R.

Qualified Opinion: This type of opinion states that except for the effects of the matter to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flow in conformity with GAAP or an OCBOA.

Related Parties: SFAS 57 defines related parties as, among others, management, owners, family members of owners or management, affiliates, or any party that "can significantly influence the management or operating policies" such that the entity might be "prevented from fully pursuing its separate interests." Related-party transactions must be fully disclosed in the notes to the financial statements, including the nature of the relationship involved, a description of the transaction, the dollar amounts of the transaction, and amounts due to and from related parties.

Review: An engagement undertaken to achieve, through the performance of inquiry and analytical procedures, limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with GAAP or, if applicable, with an OCBOA. The accountant on a review engagement must show due professional care and is required to be independent.

S Corporation: A tax status election for corporations that meet the specified requirements under which they are taxed as a partnership (i.e., income passes through to the owners, who are then taxed on their share of the corporate earnings on their personal income tax returns). S corporations do not pay the corporate income tax, and corporate losses can be claimed by the shareholders, subject to the basis and passive loss rules. The requirements are located in subchapter S of the Internal Revenue Code (IRC).

Sole Proprietorship: A business form of one person conducting business as an individual. It is not a legal, taxable entity separate from the owner. The owner is personally liable for the debts of the proprietorship. It is governed by the laws of contracts and agency. The owner may hire employees or agents (or independent contractors).

Statement of Cash Flows: One of the required financial statements. It replaced the statement of changes in financial position. Cash receipts and cash payments are classified into three categories:

1. *Operating activities.* All transactions and other events that are not investing or financing.

These generally include transactions that enter into the determination of net income—production and delivery of goods and services, interest and dividends received, and payment of interest.

2. *Investing activities.* All transactions related to the making or collecting of loans and the acquiring and disposing of debt, equity instruments, or property, plant, and equipment.

3. *Financing activities.* All transactions related to obtaining resources from owners and providing them with a return on, and a return of, their investment, and to obtaining and repaying debt.

Separate disclosure of noncash investing and financing activities is also required. Examples of such activities include obtaining an asset by entering into a capital lease, by exchange for another asset, or by the issuance of stock or debt.

Variable Interest: A contractual, ownership, or other pecuniary interest whose fair value changes with changes in the fair value of the entity's net assets.

Variable Interest Entity: An entity is a variable interest entity if its equity is not sufficient or its equity investors do not have the characteristics of a controlling financial interest.

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COMPANION TO PPC'S GUIDE TO CASH, TAX, AND OTHER BASES OF ACCOUNTING**COURSE 2****Income Tax Basis of Accounting and Other Bases of Accounting (OFSTG092)****OVERVIEW**

COURSE DESCRIPTION:	This interactive self-study course provides an introduction to preparing and reporting on financial statements prepared using the income tax basis of accounting. The course discusses general and specific considerations that should be taken into account while using the income tax basis of accounting, and applies those considerations to disclosures and reporting requirements.
PUBLICATION/REVISION DATE:	August 2009
RECOMMENDED FOR:	Users of PPC's Guide to Cash, Tax, and Other Bases of Accounting
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of financial statements
CPE CREDIT:	8 QAS Hours, 8 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours.

FIELD OF STUDY:	Accounting
EXPIRATION DATE:	Postmark by September 30, 2010
KNOWLEDGE LEVEL:	Basic

Learning Objectives:**Lesson 1—Income Tax Basis of Accounting**

Completion of this lesson will enable you to:

- Select the proper basis of accounting.
- Compare the accrual method of accounting for federal income tax purposes, the cash method of accounting for federal income tax purposes, and issues related to each.
- Identify appropriate disclosures for the income tax basis of accounting.
- Determine how income taxes are presented for taxable and pass-through entities.

Lesson 2—Other Bases of Accounting

Completion of this lesson will enable you to:

- Discuss the aspects of regulatory accounting and the applicable requirements.
- Identify the requirements for industries affected by regulatory accounting and the disclosures that should be made in the financial statements.
- Summarize other bases of accounting, including price-level, fair value, liquidation and agreed-upon.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

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ADMINISTRATIVE POLICIES:

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Lesson 1: Income Tax Basis of Accounting

INTRODUCTION

Authoritative guidance on applying other comprehensive bases of accounting exists. References to OCBOAs appear in Statements on Auditing Standards (SAS) and Statements on Standards for Accounting and Review Services (SSARS). SAS No. 62, *Special Reports* (AU 623.03), states that “an independent auditor’s judgment concerning the overall presentation of financial statements should be applied within an identifiable framework.” Ordinarily, that framework is provided by GAAP; but SAS No. 62 allows a comprehensive basis of accounting other than GAAP to be used. SSARS No. 1 at AR 100.04 defines OCBOAs for compiled and reviewed financial statements.

SSARS No. 1 includes guidance on the definitions of an OCBOA, examples of appropriate financial statement titles, and illustrative reports for compilations or reviews of OCBOA financial statements. The SSARS literature does not include guidance on disclosures in compiled or reviewed financial statements.

SAS No. 62, *Special Reports* (AU 623.09–.10), and Interpretation 14 of SAS No. 62 (AU 9623.90–.95), *Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)*, provide the only guidance for disclosures in OCBOA financial statements, stating that the financial statements should include all informative disclosures appropriate for the basis used. They also state that the basis of presentation and how it differs from GAAP should be disclosed and that the financial statements should disclose at least the substance of the information that would be disclosed if GAAP were used.

Guidance for OCBOA financial statements, particularly for compilation and review engagements, continues to evolve. In those instances when SSARS provides guidance, this course refers to that guidance. When SSARS is silent on a situation related to OCBOA financial statements (such as disclosures), the current practice is to look to SAS No. 62 and Interpretation No. 14 for guidance and to consider that guidance in the context of compiled or reviewed financial statements. Prior to the issuance of SSARS No. 15, AR 100.04, footnote 6, referred the accountant to SAS No. 62 for guidance on evaluating the adequacy of disclosures in OCBOA financial statements. Although SSARS No. 15 eliminates that reference to SAS No. 62, that guidance can still be helpful to accountants.

Learning Objectives:

Completion of this lesson will enable you to:

- Select the proper basis of accounting.
- Compare the accrual method of accounting for federal income tax purposes, the cash method of accounting for federal income tax purposes, and issues related to each.
- Identify appropriate disclosures for the income tax basis of accounting.
- Determine how income taxes are presented for taxable and pass-through entities.

INCOME TAX BASIS FINANCIAL STATEMENTS—AN INTRODUCTION

General Considerations

SAS No. 62 at AU 623.04 and SSARS No. 1 (AR 100.04) state that the basis of accounting an entity “uses or expects to use to file its income tax return” is an other comprehensive basis of accounting. That basis, referred to as the income tax basis of accounting, typically is based on federal income tax laws found in the Internal Revenue Code and related revenue rulings, regulations, and procedures. Since income tax laws deal with the determination of taxable income, they focus primarily on the measurement of revenues and expenses and, in some cases, on the determination of the basis of assets and liabilities. Income tax laws generally do not address financial statement presentation or disclosure considerations, however. This lesson provides guidance on measurement, presentation, and disclosure considerations when accountants prepare financial statements using the federal income tax basis of accounting.

Types of Entities for Income Tax Reporting Purposes

For purposes of income tax reporting, distinctions are made between the following types of entities:

- C corporations
- S corporations
- Partnerships
- Sole proprietorships

Each type of entity has its own unique characteristics and reporting requirements, and the appropriate choice for a client depends on a variety of tax and nontax considerations.

Limited liability companies (LLCs) are usually classified as partnerships for income tax reporting purposes. Therefore, this course does not specifically discuss LLCs unless their presentation or disclosure would differ from partnerships in a particular area. For example, generally accepted accounting principles (GAAP) contain certain requirements for labelling an LLC's equity section in the balance sheet.

Differences in the Entity's Taxation. The type of entity can result in significant differences in its taxation. For example, the income of C corporations may be taxed twice: once when the corporation files its income tax return and again when stockholders report dividends on their personal returns. Generally, S corporations and partnerships are not subject to income tax because their income, loss, and credits are passed through to the shareholders or partners and are included on their tax returns. Sole proprietorships are not taxpaying entities either. Sole proprietors own 100% of their businesses and report profits or losses from those businesses on their individual income tax returns.

Focus of This Lesson. Many of the provisions in the federal income tax laws apply equally to C corporations, S corporations, and partnerships. As such, this chapter focuses on preparing tax basis financial statements for C corporations. However, because certain income tax laws apply only to specific types of entities, the chapter also identifies significant differences between preparing financial statements for C corporations, S corporations, and partnerships.

This lesson is not a substitute for understanding the Internal Revenue Code (IRC) and its related revenue rulings, regulations, and procedures. Accordingly, an accountant preparing tax basis financial statements should be familiar with the federal income tax laws applicable to a particular entity.

Accounting Methods

The IRC prescribes two overall methods of accounting—the cash basis and the accrual basis. Under the cash method, income is generally recorded in the year it is actually or constructively received, and expenses are generally deducted in the year they are actually paid or the property is transferred. Under the accrual method, income generally is reported in the year earned, and expenses are generally deducted in the year incurred.

Use of Inventories. Businesses that use inventories (i.e., they produce or purchase merchandise and sell it to produce income) are generally required to use the accrual method for inventory purchases and sales. (That may result in using a hybrid overall accounting method if the accrual method is used for purchases and sales, and the cash method is used for other items of revenues and expenses. Typically, however, entities with inventories elect the accrual method to report all transactions.)

While the courts have inconsistently ruled on exactly what constitutes a significant income-producing factor, generally, they have based their conclusion on the ratio of material or merchandise to gross receipts. The Tax Court's decision in *Wilkinson-Beane, Inc.* established that when materials or merchandise do not exceed approximately 15% of gross receipts, they will not be considered a significant income-producing factor. The IRS audit guide on veterinarians refers to this 15% de facto standard established in *Wilkinson-Beane, Inc.* This threshold could be important, for example, to professional practices that exceed \$10 million in average annual gross receipts and are

thus beyond the cash method protection of Rev. Proc. 2002-28. However, 15% is not a safe harbor. Even if an entity has a materials percentage of less than 15%, the IRS may still require a change from the cash to the accrual method by arguing that the cash method significantly distorts income.

Exceptions That Allow Use of the Cash Method. The IRS has made the cash method of accounting available to qualifying taxpayers with average gross receipts of up to \$10 million as explained in the following revenue procedures:

- *Revenue Procedure 2002-28.* This guidance allows qualifying small business taxpayers to use the cash method of accounting if they meet the following criteria:
 - a. The business must have average annual gross receipts of no more than \$10 million. Gross receipts are tested by using the average of the three preceding years, and include total sales from all businesses (net of returns and allowances) plus receipts from interest, dividends, and rents, but exclude pass-through sales tax collections.
 - b. The business must not be an entity prohibited from using the cash method under IRC Sec. 448. (Section 448 also prohibits tax shelters from using the cash method.)
 - c. The principal business activity must be something other than mining, manufacturing, wholesale or retail trade, or information industries. (However, custom manufacturing according to the customer's design or specifications may qualify.) The business also must not be conducting a farming activity. However, if the principal business activity is the providing of services, including providing property incidental to those services, a taxpayer may use the cash method for all of its business activity, even if some other part of the business activity (e.g., providing property incidental to those services, which is a retail activity) is described in one of the preceding ineligible business activities. Also, if an otherwise qualifying activity is not the taxpayer's principal activity, taxable income and loss for such activity may qualify for relief if separate books and records are maintained for it.
- *Revenue Procedure 2001-10.* Under Rev. Proc. 2001-10, small businesses with average annual gross receipts for the three prior years of \$1 million or less may use the cash method of accounting even if the taxpayer would otherwise be required to use the accrual method of accounting due to the presence of inventories. Unlike Rev. Proc. 2002-28, in which the up to \$10 million exception is only available if it meets certain requirements, Rev. Proc. 2001-10 allows any business to use the cash method unless treated as a tax shelter under IRC Sec. 449(a)(3) and (d)(3). To qualify for the cash-method relief, the taxpayer must satisfy a gross receipts test.

Qualifying businesses that elect under Rev. Proc. 2002-28 to use the cash method have the option of not following the normal Section 471 inventory accounting rules. Instead, the amount capitalized as inventory may be limited to the amount of payments for materials and supplies on hand that are not incidental to providing services. Accordingly, the cost of nonincidental materials and supplies would only be deductible in the later of (a) the year the taxpayer sells the item (or consumes it in the process of providing services) to a customer or (b) the year the taxpayer pays for the item. In addition, Rev. Proc. 2002-28 clarifies that methods such as a first-in, first-out (FIFO) or an average cost method may be used to determine the amount of the allowable deduction, but that a last-in, first-out (LIFO) method may not be used. The taxpayer would not capitalize payments for materials and supplies that are incidental to providing services. The accounting for materials and supplies under Rev. Proc. 2001-10 is generally the same.

Tax Shelter. An entity with a significant purpose to avoid or evade federal income tax (i.e., a tax shelter) must use the accrual method.

Permitted Methods Based on Form of Entity. All other businesses can select accounting methods based on the following rules:

- *C Corporations.* Generally, C corporations are required to use the accrual method of accounting. However, under IRC Sec. 448, they can use the cash method if their average gross receipts are \$5 million or less *for the prior three years*. In addition, the IRC provides an exception allowing qualified personal service corporations to use the cash method.

- *S Corporations.* S corporations generally are eligible to use either the cash or accrual accounting method. However, S corporations that allocate more than 35% of their losses to shareholders who do not actively participate in the management of the business cannot use the cash method.
- *Partnerships.* Partnerships are also generally eligible to use either the cash or accrual method of accounting. However, limited partnerships generally cannot use the cash method if they allocate more than 35% of their tax losses to limited partners. In addition, if general or limited partnerships have C corporation partners, they cannot use the cash method if they have average gross receipts of greater than \$5 million for the three preceding tax years.
- *Sole Proprietorships.* Generally, sole proprietorships are eligible to use either the cash or accrual accounting method. In addition, a sole proprietor may use the accrual method for the business and the cash method for nonbusiness income and deductions. (Nonbusiness income and deductions would not be reflected in the sole proprietorship's tax basis financial statements.)

Regardless of the method used, it must clearly reflect income. If it does not, the Internal Revenue Service can require a different method.

Considering the Effects of the Alternative Minimum Tax System

Federal tax law requires certain entities to compute taxes under the regular tax system and the alternative minimum tax (AMT) system with the larger amount being the tax liability for the year. An excess of AMT over regular tax is available indefinitely as a credit against regular tax. Because certain amounts are computed differently under each system (for example, depreciation), accountants may wonder which rules to follow when they prepare tax basis financial statements for an AMT taxpayer. Generally, tax basis financial statements should reflect regular tax rules, not AMT rules, for the following reasons:

- a. Because taxes are paid under the AMT system only when it produces a higher liability than the regular tax system, an entity may be affected by the AMT system in one year, but not in the next. Switching rules from year to year could result in financial presentations that are not comparable.
- b. Tax basis financial statements generally are intended to measure results of operations rather than mirror the tax return. Because the AMT credit carryforward effectively imposes the regular tax on most entities over their lives, best practices indicate that the regular tax system should be used to measure tax basis results of operations.
- c. Record keeping could be unnecessarily complex. For example, accumulated depreciation could include a combination of AMT and regular tax system annual depreciation amounts if the taxpayer pays taxes under the AMT system in one year and the regular tax system in another. As a result, when assets are disposed of, the gain or loss may not reflect the gain or loss under either system unless additional adjustments are made.
- d. Typically, financial statement users are more familiar with the regular tax system than the AMT system.
- e. The fact that the entity is an AMT taxpayer will be adequately disclosed when the difference between the actual tax expense reported in the tax basis financial statements and the tax expected based on income reported in the financial statements is disclosed.

Nevertheless, some entities may believe they will always be an AMT taxpayer and want to follow the AMT rules when preparing tax basis financial statements. If so, that policy should be disclosed.

GENERAL CONSIDERATIONS

Can Nontaxed Entities Use the Income Tax Basis?

SAS No. 62, *Special Reports*, and SSARS No. 1 define the income tax basis at AU 623.04 and AR 100.04 as the basis of accounting an entity “uses or expects to use to file its *income tax return* for the period covered by the financial statements.” However, SAS No. 62 and SSARS No. 1 do not provide any additional guidance on what is meant by the phrase “income tax return.” If taken literally, many entities would not be able to use the income tax basis under SAS No. 62 and SSARS No. 1 since the Internal Revenue Service does not describe the annual forms they file as “income tax returns” [e.g., Form 1065 (U.S. Partnership Return of Income) and Form 990 (Return of Organization Exempt From Income Tax)].

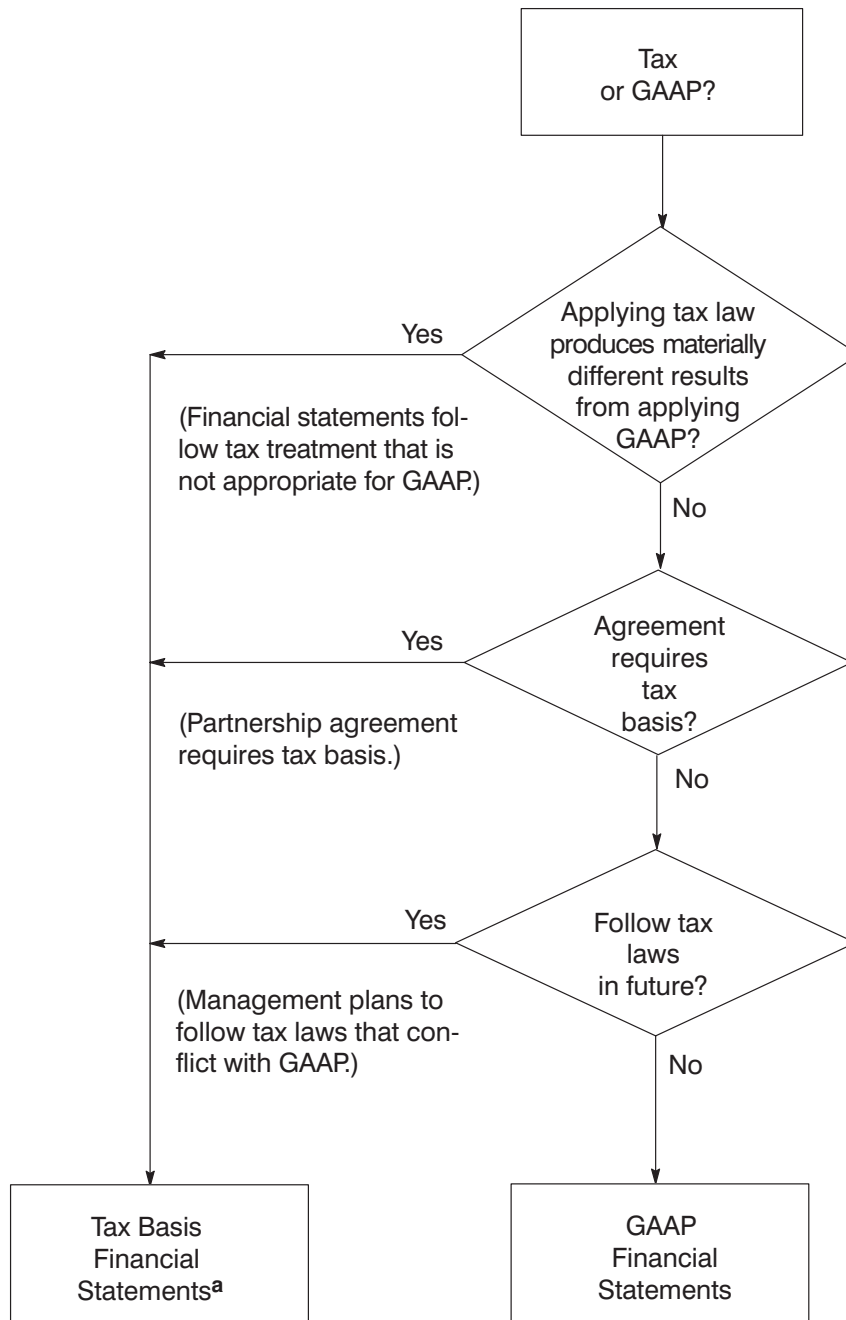
Most accountants agree that the title of the return should not be the deciding factor when determining whether a nontaxed entity may use the income tax basis. They have the following differing views about who may use the income tax basis, however:

- a. Only entities that pay income taxes file income tax returns. Thus, only those entities may use the income tax basis under AU 623.04 (AR 100.04). (For example, C corporations could use the income tax basis but S corporations, partnerships, and sole proprietorships generally could not.)
- b. Only entities whose income is ultimately taxed may use the income tax basis under SAS No. 62 and SSARS No. 1 (AR 100.04). (For example, C corporations, S corporations, partnerships, and sole proprietorships could use the income tax basis.)
- c. Entities that file a return with the Internal Revenue Service (either to report taxes owed or to report information) may use the income tax basis under SAS No. 62 and SSARS No. 1 (AR 100.04). (Under that approach, nonprofit organizations, partnerships, S corporations, C corporations, and proprietorships may use the income tax basis.)

Best practices indicate that the last alternative is a reasonable approach to follow. In addition, Interpretation 14 of SAS No. 62 (AU 9623.90–.95), *Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)*, and SSARS No. 1 (AR 100.04) provide examples of nonprofit organizations using the accounting principles followed in filing Form 990, thus acknowledging that such entities may issue income tax basis financial statements.

Determining the Appropriate Basis of Accounting

Because tax law allows entities to use methods that yield results ranging from those of the pure cash basis to GAAP, it may be difficult to determine whether tax basis financial statements should be reported on as cash basis, income tax basis, or GAAP financial statements. The following paragraphs discuss the authors' recommendations for describing the basis of accounting used to prepare the financial statements. The flowchart in Exhibit 1-1 summarizes the recommendations.

Exhibit 1-1**Determining the Appropriate Basis of Accounting When Financial Statements and Tax Return Are Substantially the Same****Note:**

- ^a When the tax return is filed using a cash basis of accounting, the financial statements may be identified as tax basis or cash basis (or modified cash basis) provided the bases do not differ significantly. However, the general preference is for profit-oriented businesses to identify such statements as tax basis.

* * *

Accrual Method of Accounting for Income Tax Reporting Purposes. If the accrual method of accounting is used to file the income tax return, the additional costs of preparing GAAP financial statements may be minimal. In that case, it normally is preferable to describe and report on the financial statements as GAAP statements since that is what third-party users generally prefer. Accordingly, best practices indicate that considering whether the differences between the income tax basis and GAAP are significant before describing the statements as prepared on the income tax basis. If the differences are not significant, no adjustments are required for financial statements to conform with GAAP, and there may be no cost advantage to providing income tax basis financial statements. For example, prescribed lives used to compute tax depreciation of long-lived assets may differ from the actual useful lives that should be used for GAAP depreciation. The differences in lives may not produce significantly different results, however.

Nevertheless, SAS No. 62 and SSARS No. 1 do not preclude entities from presenting their financial statements as being prepared on the income tax basis when the financial results do not differ materially from GAAP results. The guidance in SAS No. 62 and SSARS No. 1 addresses using a comprehensive basis other than GAAP rather than focusing on whether the income tax basis of accounting differs materially from GAAP. Therefore, if the financial results are materially the same under the tax basis and GAAP, best practices indicate that the users' expectations should be considered when determining how the statements should be described. To illustrate, assume a partnership agreement calls for preparing income tax basis financial statements because the partners are especially interested in the tax attributes of the partnership's operations. However, there are currently only insignificant differences between tax and GAAP results. Since the partners expect to see tax basis statements, best practices indicate that the statements usually should be described as income tax basis financial statements. The description of the accounting basis in the notes to the financial statements would disclose there were no material differences from GAAP. Describing the financial statements as income tax basis financial statements when the financial results are materially the same under the tax basis and GAAP could also prevent a confusing disclosure in future years if the partnership subsequently elects a tax accounting treatment that is materially different from GAAP.

Cash Method of Accounting for Income Tax Reporting Purposes. When the cash method of accounting is used to file the income tax return and the results do not differ significantly from those under the cash or modified cash basis, some accountants identify and report on the statements as cash basis or modified cash basis statements, while other accountants choose to identify and report on them as tax basis financial statements. If users expect the tax basis, the authors recommend that accountants report on that basis and title the statements accordingly. In practice, entities organized for profit generally refer to those statements as tax basis financial statements while governmental entities generally refer to them as cash or modified cash basis financial statements. Nonprofit organizations differ as to whether they refer to such statements as cash, modified cash, or income tax basis.

Nontaxable Revenues and Nondeductible Expenses

Entities should report taxable revenues and deductible expenses at the amounts reflected in the income tax return. However, in computing taxable income, income tax rules provide for the exclusion of certain tax-exempt revenues and nondeductible expenses. Those nontaxable revenues and nondeductible expenses are normally referred to as permanent differences, but some accountants refer to them as excludable items. In the respective income tax returns, they are treated as reconciling items in a schedule that reconciles "net income" with taxable income. Common examples are the receipt of tax-exempt interest income and the payment of nondeductible expenses such as penalties and premiums on officers' life insurance policies.

The following are two common questions accountants have related to nontaxable revenues and nondeductible expenses and their effect on income tax basis financial statements:

- a. How should nontaxable revenues and nondeductible expenses be presented in tax basis financial statements?
- b. Does the statement of revenues and expenses need to reflect taxable income?

Presenting Nontaxable Revenues and Nondeductible Expenses in Tax Basis Financial Statements. Measuring permanent differences and reflecting them in some way in tax basis financial statements is also necessary for the financial statements to balance. For example, the cash receipt of exempt interest income results in a debit to cash in the accounting records. Therefore, a corresponding credit is necessary for the entry to balance. Accord-

ingly, tax-exempt revenues and nondeductible expenses generally should be included in earnings in the period they are measured. That is, cash basis entities should recognize nontaxable revenues when received and nondeductible expenses when paid, and accrual basis entities should recognize nontaxable revenues when earned and nondeductible expenses when incurred.

Taxable Income and the Financial Statements. Reporting permanent differences on the statement of revenues and expenses can result in reporting net income that differs from taxable income on the tax return. As previously mentioned, that raises the question of whether the statement of revenues and expenses should reflect taxable income. Initially, it seems desirable for net income on the financial statements to agree with taxable income on the tax return (or for taxable income to at least be captioned on the statement of revenues and expenses). However, taxable income is not clearly reflected on all tax returns. For example, Form 1120 (U.S. Corporation Income Tax Return) shows an amount captioned “taxable income.” However, Form 1065 (U.S. Partnership Return of Income) and Form 1120S (U.S. Income Tax Return for an S Corporation) do not show such an amount because of items passed through separately to the owners.

Significant reasons for the difference between the tax provision in an entity's financial statements and the amount that would result from applying statutory rates to pretax income should be disclosed in the notes to the financial statements. Accordingly, *some* disclosure of nontaxable revenues and nondeductible expenses will be necessary in a taxable entity's financial statements if the amounts are material. However, that disclosure could be as simple as noting that the significant difference is primarily due to tax-exempt income without disclosing any amounts.

Reporting Taxable Income or Disclosing Nondeductible and Nontaxable Amounts. Circumstances may arise in which it is useful to provide information to users about taxable income or the amounts of nontaxable revenues and nondeductible expenses. In such cases, that information can be provided either in the notes to the financial statements or in the statement of revenues and expenses. Generally, either of the following alternatives may be appropriate:

- Present the nontaxable revenues and nondeductible expenses as separate line items on a statement of revenues and expenses that does not reconcile to taxable net income (e.g., a separate financial statement line item might be captioned “tax-free interest income on state and local government obligations”).
- Include the nontaxable revenues and nondeductible expenses in line items with taxable revenues and deductible expenses (such as interest income and other expenses), but then provide a reconciliation on the statement of revenues and expenses or in the notes that starts with pretax income and lists permanent differences and deductions subject to limitations to arrive at taxable income.

If a reconciliation to taxable income is presented in the statement of revenues and expenses, the disclosure of the change in retained earnings can reflect either (a) the net income amount that would have been shown on the statement of revenues and expenses had the reconciliation not been provided or (b) the two components of that amount, consisting of taxable income and amounts that were nontaxable or nondeductible. If the change in retained earnings reflects an amount for nontaxable revenues and nondeductible expenses, the summary of significant accounting policies might include a disclosure such as the following:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Income Taxes

Certain income and expense items are not fully taxable or deductible for federal income tax purposes and are therefore excluded from taxable income. Those items include exempt interest income, dividend exclusions, disallowed passive losses, and depletion in excess of cost. Those excluded items are reflected in the statement of revenues and expenses as an increase or decrease in taxable income. The corresponding increase or decrease is reflected in the statement of changes in retained earnings.

Exhibit 1-2 illustrates an example statement of revenues and expenses that presents nontaxable revenues and nondeductible expenses as separately captioned line items. Exhibit 1-3 illustrates an example statement of retained earnings that would be appropriate for that type of presentation. Exhibit 1-4 illustrates an example statement of

revenues and expenses that reconciles to taxable income. Exhibit 1-5 illustrates an example statement of retained earnings that could be prepared for that type of presentation.

Exhibit 1-2

**White & Pitts Engineering, Inc.
Statement of Revenues and Expenses—
Income Tax Basis
Year Ended December 31, 20X8**

SALES	\$ 1,858,202
COST OF SALES	<u>1,465,749</u>
GROSS PROFIT ON SALES	392,453
SELLING AND ADMINISTRATIVE EXPENSES	<u>250,857</u>
INCOME FROM OPERATIONS	141,596
OTHER INCOME (EXPENSE)	
Tax-free interest income on state and local government obligations	27,873
Other interest income	8,468
Dividend income subject to dividend received deduction	22,104
Interest expense	(92,910)
Nondeductible expenses	(12,105)
Miscellaneous income	<u>4,502</u>
	<u>(42,068)</u>
INCOME BEFORE INCOME TAXES	99,528
INCOME TAX EXPENSE	<u>12,072</u>
NET INCOME	<u><u>\$ 87,456</u></u>

* * *

Exhibit 1-3

**White & Pitts Engineering, Inc.
Statement of Retained Earnings—
Income Tax Basis
Year Ended December 31, 20X8**

BALANCE, January 1, 20X8	\$ 561,043
Net income	<u>87,456</u>
BALANCE, December 31, 20X8	<u><u>\$ 648,499</u></u>

* * *

Exhibit 1-4

White & Pitts Engineering, Inc.
Statement of Revenues and Expenses—Income Tax Basis
Year Ended December 31, 20X8

SALES	\$ 1,858,202
COST OF SALES	<u>1,465,749</u>
GROSS PROFIT ON SALES	392,453
SELLING AND ADMINISTRATIVE EXPENSES	<u>250,857</u>
INCOME FROM OPERATIONS	141,596
OTHER INCOME (EXPENSE)	
Interest income	36,341
Dividend income	22,104
Interest expense	(92,910)
Miscellaneous expenses	(12,105)
Miscellaneous income	<u>4,502</u>
Total other expense (net)	<u>(42,068)</u>
INCOME BEFORE EXCLUDABLE ITEMS AND PROVISION FOR INCOME TAXES	99,528
EXCLUDABLE ITEMS	
Tax-free interest income on state and local government obligations	(27,873)
Dividend income subject to dividend received deduction	(15,472)
Nondeductible expenses	<u>12,105</u>
Total excludable items	<u>(31,240)</u>
TAXABLE INCOME BEFORE INCOME TAXES	68,288
INCOME TAX EXPENSE	<u>12,072</u>
TAXABLE INCOME	<u><u>\$ 56,216</u></u>

* * *

Exhibit 1-5

White & Pitts Engineering, Inc.
Statement of Retained Earnings—Income Tax Basis
Year Ended December 31, 20X8

BALANCE, January 1, 20X8	\$ 561,043
Taxable income	56,216

Excludable items	<u>31,240</u>
BALANCE, December 31, 20X8	<u>\$ 648,499</u>

Note: The statement of retained earnings could reflect only the taxable income amount that would have been shown on the statement of revenues and expenses had the reconciliation not been provided. Therefore, the illustrated statement of retained earnings in Exhibit 1-3 could be followed rather than the example in this exhibit.

* * *

Errors in the Tax Returns

SAS No. 62 and SSARS No. 1 (AR 100.04) define the income tax basis as the basis of accounting the entity “uses or expects to use to file its income tax return.” However, the income tax return may include known errors. For example, errors may be included in the income tax return for one of the following reasons:

- The errors were not material to the income tax return and were not corrected.
- Federal income tax laws require the entity to continue using an erroneous method of accounting until the entity receives IRS approval to change.
- The entity uses a tax position for a material new transaction that cannot be supported.

In the first two situations, the accountant could sign the income tax return as the preparer. Accordingly, the authors believe the accountant could prepare and report on the financial statements without modifying the report for a departure from the income tax basis of accounting. In the third situation, however, the authors do not believe the accountant could report on the financial statements without modifying the report. (In such situations, the accountant also should consider declining association with the financial statements.)

Changes Affecting the Financial Statements

Change in Basis of Accounting. A decision by an entity to change its basis of accounting from generally accepted accounting principles to the income tax basis (or vice versa) does not constitute a change in accounting principle.

Change in Tax Law or Accounting Principle. According to SAS No. 62 (AU 623.31, footnote 36), a change in tax law is not considered to be a change in accounting principle. On the other hand, if tax laws have not changed but an entity changes its method of accounting for an item for tax purposes, it would be reflected as a change in accounting principle. Changes in accounting principles in income tax basis financial statements usually occur through elections such as the following:

- A change from the cash to the accrual method of accounting for income tax reporting purposes
- A change in the method of valuing inventories such as from FIFO to LIFO
- A change in the method of reporting income from contracts such as from the completed-contract method to the percentage-of-completion method

For income tax reporting purposes, most accounting changes are applied retrospectively as of the beginning of the year of change, and the cumulative effect is amortized to taxable income prospectively over a prescribed period using the straight-line method. The requirements for GAAP are based on SFAS No. 154, *Accounting Changes and Error Corrections*, a replacement of APB Opinion No. 20 and FASB Statement No. 3 (FASB ASC 250-10). This discussion provides guidance on changes in accounting principles for both cash and tax basis financial statements.

Change in Fiscal Year. A taxpayer may, with the permission of the Commissioner of the IRS, change its accounting period, e.g., from a December 31 year end to a June 30 year end. In addition, the IRS requires taxpayers to change their fiscal year in certain circumstances, e.g., a corporation electing S corporation status is required to change to a December 31 year end unless it can show the fiscal year is its natural business year or it pays a deposit. A change in fiscal year requires a short-year (less than 12 months) tax return.

When entities adopt a change in tax year, they also usually change their fiscal year for financial reporting purposes. Thus, the financial statements of the year of change would cover less than twelve months. (In rare situations, however, the entity may want the tax basis financial statements to reflect a full year of operations even though the tax return is filed for less than a full year.) Neither SFAS No. 154, *Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3* (FASB ASC 250-10), nor other authoritative pronouncements discuss a change in an entity's fiscal year.

A technical practice aid at TIS 1800.03 indicates that, generally, the effect of making the change should be disclosed in the current period to make the statements more meaningful. The authors believe that disclosure should be made in tax basis financial statements whenever the year of change is presented, e.g., in comparative financial statements. Best practices indicate that the short-year financial statements may be presented in comparative form with complete years as long as the change in fiscal year is disclosed, and the financial statements are appropriately captioned as illustrated in the following:

- BARTON'S BUSINESS SUPPLIES, INC.
STATEMENTS OF ASSETS, LIABILITIES AND EQUITY—
INCOME TAX BASIS
December 31, 20X8 and June 30, 20X8

December 31, 20X8	June 30, 20X7

- BARTON'S BUSINESS SUPPLIES, INC.
STATEMENTS OF REVENUES AND EXPENSES—
INCOME TAX BASIS
Six Months Ended December 31, 20X8
and Year Ended June 30, 20X8

Six Months Ended December 31, 20X8	Year Ended June 30, 20X7

The following illustrates appropriate note disclosure of the change in fiscal year:

NOTE B—FISCAL YEAR CHANGE

Effective for the calendar year beginning January 1, 20X9, the Company will change from a fiscal year end of June 30 to December 31. A six-month fiscal transition period from July 1, 20X8 through December 31, 20X8, precedes the start of the new calendar-year cycle.

Presenting Changes in Equity and Capital Amounts

Changes in Stockholders' Equity. Paragraphs 9 and 10 of APB Opinion No. 12 (FASB ASC 505-10-50-2), *Omnibus Opinion 1967* (FASB ASC 505-10-50-2), require disclosure of changes in the separate accounts comprising stockholders' equity when both financial position and results of operations are presented. Interpretation 14 of SAS No. 62 (AU 9623.90–.95) states that income tax basis financial statements with items requiring disclosure under GAAP should either follow the GAAP disclosure requirements for those items or provide information that

communicates the substance of those GAAP requirements. Accordingly, best practices indicate that tax basis financial statements that present both financial position and results of operations should disclose changes in the components of stockholders' equity either on the face of the financial statements or in the notes. Paragraph provides additional guidance for disclosing changes in the components of stockholders' equity.

Changes in Retained Earnings. Under GAAP, changes in retained earnings are required to be disclosed whenever results of operations are presented. The concept of "results of operations" is not defined for the income tax basis of accounting. However, the authors believe the general principles for reporting results of operations should be applied to income tax basis statements when relevant. Thus, disclosure of the changes in retained earnings (through a separate statement of retained earnings, combined with a statement of revenues and expenses, presented on the face of the tax basis balance sheet, or through disclosure in the notes) should be presented for tax basis financial statements that include an income statement. The authors believe the most common presentation for C corporations and S corporations is to report the changes in retained earnings on a statement of revenues, expenses, and retained earnings.

Statement of Cash Flows

According to Interpretation 14 of SAS No. 62 (AU 9623.90–.95), a statement of cash flows is not required to be presented in income tax basis financial statements. In practice, however, some financial statements prepared on the accrual basis used for income tax reporting include a statement of cash flows. Best practices indicate that tax basis financial statements, like GAAP statements, can be useful when they consist of a full set of statements (i.e., they present financial position, results of operations, and cash flows).

Offsetting Amounts in the Financial Statements

Tax literature does not address the issue of offsetting certain amounts in tax basis financial statements. The authors believe the presentation depends on whether the amounts are (a) receivables and payables or (b) contra accounts.

Offsetting Receivables and Payables. For GAAP presentations, receivables and payables *may* be offset if the reporting entity has the ability and intent to offset. For tax reporting purposes, however, receivables and payables have separate bases, and offsetting is not mentioned in the IRC, regulations, or interpretive guidance.

Offsetting Contra Accounts. GAAP generally offsets accounts that have no substance apart from each other. The determination of tax bases clearly takes a similar approach in certain instances, such as accumulated depreciation and imputed interest arising from discounting. However, in other instances, the income tax literature is silent. In those situations, best practices indicate that the two accounts should be offset if that captures the substance of the transaction. For example, GAAP requires offsetting the deferred gross profit on installment sales against the related receivable, but the income tax literature is silent. Nevertheless, the receivable cannot be reduced without triggering a reduction of the deferred gross profit. Therefore, the authors believe offsetting captures the substance of the transaction.

Related-Party Transactions

The definition of a related party varies depending on the IRC section. The determination of a related party for income tax reporting purposes is an important concept because the appropriate IRC section specifies the tax reporting treatment depending on the type of transaction. For example, IRC Section 267 contains the rules governing the treatment of losses resulting from related party transactions. Those rules may require losses resulting from the sale or exchange of property between related parties to be deferred or disallowed altogether. Similarly, an accrual basis taxpayer is placed on the cash basis to determine the deductibility of items accrued, but not yet paid, to related cash basis taxpayers. For instance, an accrual basis taxpayer cannot deduct interest expense owed to a cash-basis related party until the year the payment is included in the related party's income.

SFAS No. 57, *Related Party Disclosures* (FASB ASC 850-10-20), defines related parties for which it requires disclosures in GAAP financial statements. Accordingly, certain transactions, such as transactions with an entity's management, may not be disclosed as a related party transaction in those tax basis financial statements.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. The income of which entity could be taxed twice?
 - a. Sole proprietorship.
 - b. Partnership.
 - c. C corporation.
 - d. S corporation.
2. In which of the following scenarios would the taxpayer be allowed to use the cash method instead of the accrual method of accounting?
 - a. Chutes & Ladders is approved to use the cash method under IRC Sec. 448.
 - b. The School's In store sells school uniforms wholesale.
 - c. The Town Mall has average annual gross receipts of \$17 million.
 - d. Popeye's Parlor has average annual gross receipts of \$990,000.
3. Desert Rose Enterprises pays taxes under the alternative minimum tax (AMT) system in 2009. Which of the following reasons supports Desert Rose using the regular tax rules for its tax basis financial statements?
 - a. The financial statements should mirror the tax return.
 - b. Financial statement users are more familiar with the AMT system than the alternative.
 - c. Switching rules each year may result in annual financial statements that are not comparable.
4. In which of the following scenarios should the company use the income tax basis of accounting instead of generally accepted accounting procedures (GAAP)?
 - a. The management of Moon, Inc. plans to follow tax laws in the future that will conflict with GAAP.
 - b. When tax law is applied to Shasta Corp.'s financial statements, the results are similar to the results of applying GAAP.
5. Which of the following scenarios illustrates a change in accounting principle?
 - a. Finch Corp. changes from the cash to the accrual method for income tax reporting purposes.
 - b. Blue Jay Ltd.'s financial statements are affected by a change in tax law.
 - c. OwlCo changes its basis of accounting from GAAP to the income tax basis of accounting.
6. Which of the following reports or disclosures are appropriate for an entity that presents income tax basis financial statements?
 - a. Tide Town presents a statement of cash flows with its income tax basis financial statements.
 - b. Laguna Springs discloses related party transactions in its financial statements based on the definitions in the Internal Revenue Code (IRC), instead of SFAS No. 57.

7. Which of the following statements regarding related-party transactions is most accurate?
- a. Certain transactions, such as transactions with an entity's management should always be disclosed.
 - b. The definition of a related party stays the same regardless of the type of transaction.
 - c. SFAS No. 57, *Related-Party Disclosures*, contains rules governing the treatment of related-party transactions.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. The income of which entity could be taxed twice? **(Page 118)**
 - a. Sole proprietorship. [This answer is incorrect. Because sole proprietors own 100% of their business, they report profits and losses on their individual income tax returns. Therefore, the proprietorship is not a taxpaying entity.]
 - b. Partnership. [This answer is incorrect. Partnerships are typically not subject to income tax because they pass income, loss, and credits through to their partners to be included on the partners' tax returns. Thus, the partnership is not a taxpaying entity.]
 - c. **C corporation.** [This answer is correct. A C corporation can be taxed when the corporation files its income tax return, and then again when the stockholders report dividends on their personal returns.]
 - d. S corporation. [This answer is incorrect. An S corporation is not a taxpaying entity. Because an S corporation passes income, loss, and credits through to its shareholders (to be included on the shareholders' tax returns), generally it is not subject to income tax.]
2. In which of the following scenarios would the taxpayer be allowed to use the cash method instead of the accrual method of accounting? **(Page 119)**
 - a. Chutes & Ladders is approved to use the cash method under IRC Sec. 448. [This answer is incorrect. IRC Sec. 448 limits entities eligible to use the cash method; it does not approve them to use it.]
 - b. The School's In store sells school uniforms wholesale. [This answer is incorrect. To qualify for an exception to use the cash method, a taxpayer's principal business activity must be something other than manufacturing, mining, information industries, a farming activity, or wholesale or retail trade.]
 - c. The Town Mall has average annual gross receipts of \$17 million. [This answer is incorrect. However, if Town Mall had average annual gross receipts of \$10 million or less over the past three years, it would have qualified to use the cash method.]
 - d. **Popeye's Parlor has average annual gross receipts of \$990,000.** [This answer is correct. A small business with \$1 million or less in average annual gross receipts for the three previous years may use the cash method even if, otherwise, the taxpayer would have had to use the accrual method due to the presence of inventories.]
3. Desert Rose Enterprises pays taxes under the alternative minimum tax (AMT) system in 2009. Which of the following reasons supports Desert Rose using the regular tax rules for its tax basis financial statements? **(Page 120)**
 - a. The financial statements should mirror the tax return. [This answer is incorrect. Generally tax basis financial statements are intended to measure the results of operations, not mirror the tax return. The regular tax system should be used to measure the tax basis results of operations because AMT credit carryforward effectively imposes the regular tax on most entities over their lives.]
 - b. Financial statement users are more familiar with the AMT system than the alternative. [This answer is incorrect. The opposite is true—usually, users of financial statements are more familiar with the regular tax system than the AMT system.]
 - c. **Switching rules each year may result in annual financial statements that are not comparable.** [This answer is correct. The AMT system is only used when it produces a higher liability than the regular

system; therefore, Desert Rose could just as likely pay taxes under the regular system in the next year.]

4. In which of the following scenarios should the company use the income tax basis of accounting instead of generally accepted accounting procedures (GAAP)? **(Page 123)**
 - a. **The management of Moon, Inc. plans to follow tax laws in the future that will conflict with GAAP. [This answer is correct. Under these circumstances, it would be appropriate for Moon to use the income tax basis of reporting instead of GAAP to present its financial statements thus preventing a confusing disclosure in future years.]**
 - b. When tax law is applied to Shasta Corp.'s financial statements, the results are similar to the results of applying GAAP. [This answer is incorrect. SAS No. 62 does not preclude entities from presenting financial statements on the income tax basis when the financial results do not differ materially from GAAP results, but there is no mandate to do so. However, if Shasta Corp.'s financial statements followed tax treatment that is not appropriate for GAAP, then it should present its financial statements in the income tax basis of accounting.]
5. Which of the following scenarios illustrates a change in accounting principle? **(Page 127)**
 - a. **Finch Corp. changes from the cash to the accrual method for income tax reporting purposes. [This answer is correct. This election would be considered a change in accounting principle. If Finch Corp. elected to change its method of valuing inventories from FIFO to LIFO (or vice versa) that would also be a change in accounting principle.]**
 - b. Blue Jay Ltd.'s financial statements are affected by a change in tax law. [This answer is incorrect. The guidance found in SAS No. 62 says that a change in tax law is not considered a change in accounting principle.]
 - c. OwlCo changes its basis of accounting from GAAP to the income tax basis of accounting. [This answer is incorrect. An entity's decision to change its basis of accounting from GAAP to the income tax basis (or from the income tax basis back to GAAP) does not constitute a change in accounting principle.]
6. Which of the following reports or disclosures are appropriate for an entity that presents income tax basis financial statements? **(Page 129)**
 - a. Tide Town presents a statement of cash flows with its income tax basis financial statements. [This answer is incorrect. According to the guidance found in Interpretation 14 of SAS No. 62, a statement of cash flows is not required in an income tax basis financial statement presentation. However, should Tide Town decide that it wants to present a statement of cash flows anyway, such a presentation is not prohibited.]
 - b. **Laguna Springs discloses related party transactions in its financial statements based on the definitions in the Internal Revenue Code (IRC), instead of SFAS No. 57. [This answer is correct. SFAS No. 57 defines related parties for GAAP financial statements, so it is believed to be appropriate guidance for defining related parties for income tax basis financial statements. However, if Laguna Springs' accountant wishes to use IRC definitions for the related party disclosures instead, that is permitted. The difference from GAAP should be disclosed in the summary of significant accounting policies.]**
7. Which of the following statements regarding related-party transactions is most accurate? **(Page 129)**
 - a. Certain transactions, such as transactions with an entity's management should always be disclosed. [This answer is incorrect. certain transactions, such as transactions with an entity's management, may not be disclosed as a related party transaction in those tax basis financial statements.]
 - b. The definition of a related party stays the same regardless of the type of transaction. [This answer is incorrect. The definition of a related party varies depending on the IRC section. The determination of a

related party for income tax reporting purposes is an important concept because the appropriate IRC section specifies the tax reporting treatment depending on the type of transaction.]

- c. SFAS No. 57, *Related-Party Disclosures* (FASB ASC 850-10-20), contains rules governing the treatment of related-party transactions. [This answer is incorrect. IRC Section 267 contains the rules governing the treatment of losses resulting from related party transactions. Those rules may require losses resulting from the sale or exchange of property between related parties to be deferred or disallowed altogether. Similarly, an accrual basis taxpayer is placed on the cash basis to determine the deductibility of items accrued, but not yet paid, to related cash basis taxpayers.]
- d. **It is important to make a determination of a related party for income tax purposes. [This answer is correct. The determination of a related party for income tax reporting purposes is an important concept because the appropriate IRC section specifies the tax reporting treatment depending on the type of transaction.]**

ACCOUNTING FOR FEDERAL INCOME TAX PURPOSES—ACCRUAL METHOD

Under the accrual method of accounting for income tax reporting purposes, income generally is reported in the year *earned*, and expenses generally are deducted in the year *incurred*. Entities using the accrual method report income when the right to receive the income has occurred, and the amount can be determined with reasonable accuracy. (Thus, it is not the actual receipt but the *right to receive* that determines when entities record the income.) Deductions under the accrual method are allowable in the year in which all of the following conditions are met:

- a. All events necessary to establish the fact of liability or deduction have occurred.
- b. The amount of the liability or deduction is determinable with reasonable accuracy.
- c. Economic performance has occurred.

Generally, economic performance occurs when property or services are provided to (or by) another party, or when the property is used.

Safe Harbor Rule

Under a special safe harbor exception to the general economic performance rule, economic performance is deemed to occur when payment is made if property or services can reasonably be expected to be provided to the business within 3¹/₂ months of payment. This means an accrual method business can take a deduction in the year of payment if it reasonably expects the property or services to be provided within 3¹/₂ months of payment. Otherwise, economic performance does not occur until the property or services are provided to the business.

Expenses Deductible under Recurring Item Exception. The recurring item exception, as discussed in IRC Section 461, allows an accrual basis entity to currently deduct expenses that, under the economic performance rules, would not be deductible until a later tax year. It allows an item to be taken into account in the year it becomes fixed and determinable if economic performance occurs on or before the earlier of (a) 8¹/₂ months following the close of the tax year or (b) the date the entity files a timely tax return. The deduction is available only for immaterial expenses or where the matching of income and expense is better served by using the recurring item method, as explained in the following:

- a. *Immaterial Expenses.* Immateriality is defined both in absolute terms and in comparison with other items of income and expense. Additionally, the tax regulations note that the expense must be immaterial for financial statement purposes under generally accepted accounting principles.
- b. *Better Matching of Income and Expenses.* The better-matching standard is automatically deemed to be met for the following types of liabilities:
 - (1) Recurring rebates and refunds
 - (2) Awards, prizes, and jackpots
 - (3) Insurance, warranty, and service contracts
 - (4) Taxes

Therefore, the materiality standard is not applicable to those types of liabilities or others that provide a better matching of the entity's income and expense.

Expenses ineligible for the recurring item exception are interest; workers' compensation claims, tort, breach of contract, and violation of law claims; liabilities incurred by a tax shelter; and other liabilities not specifically addressed by the economic performance statute and regulations.

Specific Measurement and Presentation Considerations—Tax Basis Balance Sheet

Trade Notes and Accounts Receivable. Under the income tax accrual method, entities must use the specific charge-off method to deduct bad debt losses related to trade notes and accounts receivable. Under that method, uncollectible receivables are not charged to expense until collection efforts have been exhausted and they become worthless. (That differs from GAAP requirements to provide an allowance for receivables that probably will not be collected.)

Inventory. The IRS generally requires companies to capitalize inventory on hand whenever it is necessary to clearly determine taxable income, which usually is the case when the production, purchase, or sale of merchandise is an income-producing factor. Recording inventory for tax purposes requires consideration of the following:

- a. *Valuation.* Generally, entities may value inventory for tax purposes at cost or lower of cost or market. (That differs from GAAP, which requires inventory to be reported at lower of cost or market.) An entity that chooses to value inventory at lower of cost or market for tax purposes must apply that method on an item-by-item basis. It may not value the entire inventory at cost and again at market, with the inventory amount being the lower aggregate total.

The IRS traditionally viewed rolling-average inventory valuation as a method of accounting that does not clearly reflect income, especially when inventory is held for several years or costs fluctuate substantially. However, many industries consider the rolling-average method an accurate estimate of costs and use a rolling-average method for financial statement purposes. The IRS reversed its stance on rolling-average inventory valuations in Rev. Proc. 2008-43. Now, the IRS generally will view a rolling-average method that is used to value inventories for financial accounting purposes as clearly reflecting income for federal income tax purposes. Rev. Proc. 2008-43 provides two safe harbors under which a taxpayer's rolling-average method is deemed to clearly reflect income. However, if inventory is held for several years or costs fluctuate substantially, a rolling-average cost method may or may not clearly reflect income, depending on the particular facts and circumstances. In addition, if a taxpayer does not use a rolling-average method for financial accounting purposes, the rolling-average method may not accurately determine costs or clearly reflect income for federal income tax purposes.

- b. *Identification Methods.* In addition to determining the value of inventory, entities must identify the items included in ending inventory. Acceptable methods for identifying items in inventory are (1) specific identification, (2) first-in, first-out (FIFO), and (3) last-in, last-out (LIFO). To use the LIFO method, however, entities must comply with certain requirements in the federal income tax laws. One of those requirements is to use the cost method to value inventory.

The specific identification method typically is limited to large or unique items, such as automobiles at a car dealership, since those items can be readily identified and assigned their actual cost. (It may be impracticable to use that method when an entity has large numbers of intermingled goods.) The FIFO method assumes the first items purchased are the first items sold. (Thus, inventories consist of the most recently purchased items.) The LIFO method assumes just the opposite. That is, it assumes that the most recently purchased items were sold first and that inventory consists of the oldest purchased items.

- c. *Capitalization of Indirect Costs.* IRC Section 263A requires certain indirect costs to be allocated to inventory and included in its cost. Indirect costs that must be capitalized include indirect labor, officers' compensation, pension and other related costs, employee benefit expenses, depreciation, rent, taxes, utilities, insurance, and repairs and maintenance. (Depending on the nature of the entity's operations, the indirect costs that must be included in inventory for tax reporting may or may not have to be included in inventory for GAAP purposes.) IRC Section 263A only applies to inventory valued at cost. It does not affect the market value used to determine lower of cost or market values unless market value is determined by reference to replacement cost or reproduction cost. In addition, the IRC exempts resellers of personal property from IRC Section 263A's requirements if average annual gross receipts for the previous three tax years are \$10 million or less. GAAP, specifically SFAS No. 151, *Inventory Costs—an amendment of ARB No. 43, Chapter 4* (FASB ASC 330-10-30-3), requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of production facilities.

Investments. The measurement of investments for income tax reporting depends on the type of investment as follows:

- a. *Investments in Debt and Marketable Equity Securities.* Investments in debt and marketable equity securities generally are carried at cost for income tax reporting purposes regardless of their fair value at the end of the period. Accordingly, gains and losses under the tax basis generally are recognized only when realized. Permanent declines in investments are only recorded when the investments are disposed of. (Federal income tax laws do not allow a deduction for unrealized losses.) Under GAAP, entities account for marketable equity securities and debt securities other than those they intend to hold to maturity at fair value in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FASB ASC 320-10).
- b. *Investments in Nonmarketable Equity Securities.* For GAAP purposes, investments in *nonmarketable* equity securities are accounted for at cost, under the equity method, or through consolidation depending on the percentage of voting stock held. Income tax rules generally require entities to use the cost method and, accordingly, recognize earnings as distributions are received. If a C corporation is included in the entity's consolidated income tax return, however, the investment should be consolidated in tax basis financial statements.
- c. *Investments in Pass-through Entities.* Investments in S corporations and partnerships are generally reported using the equity method, regardless of the level of ownership. Application of the equity method for tax reporting purposes may differ from GAAP, however. For example, the underlying earnings of the investee are determined using the tax basis of accounting, intercompany transactions are not eliminated before calculating the equity method adjustment, and the basis of the investment may be reduced below zero for tax reporting purposes in situations where it would not be reduced under GAAP.

As a general rule, the amount reported for an investment in a pass-through entity should be the tax basis capital reported in the Schedule K-1. That general rule applies even when there is a negative balance or when there is a positive balance but the investor is unable to use some of the losses passed through because of the limitations of the at-risk or passive activity rules. Best practices indicate that is appropriate because, ultimately, those loss carryforwards will be used. On the other hand, some entities believe the tax basis of the investment should not be reduced for losses limited under the at-risk or passive activity rules until they are allowed for income tax purposes.

Prepaid Expenses. Expenses paid in advance (such as rent, insurance, and interest) may not be fully deductible in the year paid if the payment creates an asset extending substantially beyond the end of the year. In that case, only the portion attributable to the year of payment may be deducted. The balance can be deducted only over the period to which it applies. GAAP requires similar treatment for expenses paid in advance.

Property and Equipment. Valuing and depreciating property and equipment using income tax requirements often results in differences from measurements that would be required by GAAP. The following are some of the more common differences:

- For tax purposes, post-1980 acquisitions of property and equipment are depreciated on the Accelerated Cost Recovery System (ACRS) and the Modified Accelerated Cost Recovery System (MACRS), depending on the year the property was placed into service. ACRS and MACRS eliminate the need to determine the useful life of an asset and narrow the selection of a depreciation method. Because GAAP merely requires the cost of depreciable assets to be allocated to expense over the expected useful lives of the assets in a systematic manner, the accelerated tax depreciation methods will sometimes approximate GAAP depreciation. However, tax depreciation methods may not approximate GAAP because their prescribed lives and the method's view on salvage values will be substantially different from those that must be used under GAAP and because of bonus depreciation and Section 179 deductions.
- Section 179 of the Internal Revenue Code allows entities to treat up to a prescribed maximum portion of qualifying property as deductions in the year of acquisition rather than as capital expenditures. (Under GAAP, such purchases would be capitalized and depreciated over their estimated useful lives.) The deduction reduces the depreciable basis of the assets for tax purposes and is included in the depreciation

deduction for C corporations on the tax return. Thus, one of the most common presentations for C corporations is to also include Section 179 expense in depreciation expense in income tax basis financial statements. [Because the Section 179 deduction reduces the depreciable basis of the asset for tax purposes, some practitioners choose to record the offsetting adjustment directly to the cost of the asset (i.e., the asset would be presented on the statement of assets, liabilities, equity—tax basis *net* of the Section 179 deduction). Others, however, choose to record the offsetting Section 179 adjustment to the contra asset account of accumulated depreciation (i.e., the asset would be presented on the statement of assets, liabilities, equity—tax basis at cost or gross with the offsetting Section 179 adjustment included in the accumulated depreciation account).

- Assets contributed by an owner may be valued at the owner's tax basis rather than at the fair value required for GAAP by APB Opinion No. 29, *Accounting for Nonmonetary Transactions* (FASB ASC 845-10-30-1).
- Requirements for capitalizing leases are more flexible than for GAAP. Also, the income tax rules require amortization of assets under capitalized leases over the depreciable lives used for income tax reporting, whereas SFAS No. 13, *Accounting for Leases* (FASB ASC 840-30-35-1), requires depreciation of some capitalized leases over the lease term.
- SFAS No. 62 (FASB ASC 835-20-30-10; 835-20-30-11; 835-20-30-12; 835-20-30-9; 835-20-55-4), *Capitalization of Interest Cost in Situations Involving Certain Tax-exempt Borrowings and Certain Gifts and Grants* (FASB ASC 835-20-30-10), requires offsetting certain earnings against capitalized interest, which is not permitted for income tax reporting.
- The use of the purchase method to account for the acquisition of the stock of a company may result in a different depreciable basis for income tax reporting than for GAAP.
- Additional differences in how property and equipment are accounted for under authoritative tax sources versus GAAP include the following:
 - Interest income on tax-exempt debt during the construction period is offset against the financial basis of the asset under GAAP but is included in taxable income for income tax reporting purposes.
 - The Uniform Capitalization rules require certain costs to be capitalized for income tax reporting purposes that are not capitalized under GAAP.
 - Losses on trade-ins are capitalized for income tax reporting purposes but are expensed under GAAP.
 - Sales tax on depreciable assets is capitalized for GAAP but deducted for income tax reporting purposes.
 - A gain arising from receiving cash on trade-ins is recognized under GAAP but offset against the tax basis of the asset for income tax reporting purposes.
 - A step-up in the tax basis of land for a transfer of noncontrolling partnership interests is not recognized under GAAP.
 - Land contributed by a partner is recorded at its fair market value at the date of the contribution for GAAP but at the partner's basis for income tax reporting purposes.

Recent legislation has significantly increased the portion of the cost of qualifying property that entities may effectively deduct in the year of acquisition, thereby increasing the difference between depreciation expense for income tax reporting and the amount that would be reported under GAAP. This is a result of increases in the Section 179 deduction provided by the various tax acts since 2003. The Small Business Work and Opportunity Act of 2007 increased and extended the Section 179 deductions until 2010. The Economic Stimulus Act significantly enhanced the Section 179 deduction break for tax years beginning in 2008 and the American Recovery and Reinvestment Act of 2009 (the Stimulus Act) extends the enhanced Section 179 allowance for tax years beginning in 2009. For tax years beginning in 2010 and beyond, the normal Section 179 rules apply.

Recent Increases in the Section 179 Deduction and Bonus Depreciation. The Economic Stimulus Act of 2008 (the 2008 Act) significantly increased the portion of the cost of qualifying property that entities may effectively deduct in the year of acquisition. For qualifying property purchased and placed in service during the tax year that begins in 2008, the 2008 Act increased the maximum Section 179 deduction from \$128,000 to \$250,000. The American Recovery and Reinvestment Act of 2009 (the Stimulus Act) extends the \$250,000 Section 179 allowance by one year, through tax years beginning in 2009. The Stimulus Act also extended the 2008 Act's increase in the phase-out threshold of the cost of qualifying additions beyond which there is a dollar-for-dollar reduction in the Section 179 deduction. Thus, the phase-out threshold is \$800,000 through tax years beginning in 2009.

For qualified property placed in service for assistance in disasters declared after 2007 and occurring before 2010, the Section 179 deduction limit is increased by the lesser of (1) \$100,000 or (2) the cost of qualified Section 179 disaster assistance property placed in service during the tax year. The qualifying property threshold (i.e., when the deduction begins to phase out) is increased by the lesser of (1) \$600,000 or (2) the cost of qualified Section 179 disaster assistance property. Therefore, for example—

- An entity with qualifying additions of \$250,000 could deduct all of those additions in the year of acquisition.
- An entity with qualifying additions of \$1,250,000 could not deduct any of its additions in the year of acquisition because the total cost exceeds the \$800,000 phase-out limitation by more than \$250,000, which is the maximum deduction allowed under IRC Sec. 179. Deductions lost because of the phase-out provision cannot be carried forward to future years.

The Section 179 deduction continues to be limited by the amount of taxable income before the deduction. Therefore, for example, no Section 179 deduction is allowable in the year there is a taxable loss before the deduction. Similarly, if the entity has qualifying additions of \$100,000 and taxable income before the deduction of \$50,000, the Section 179 deduction for the year is limited to \$50,000. However, the remainder can be carried forward.

The 2008 Act also provided a bonus depreciation deduction of 50% of the depreciable basis of qualifying property purchased and placed in service during the 2008 tax year. The Stimulus Act extends the 50% first-year bonus depreciation break to cover qualifying new (not used) assets that are placed in service by no later than 12/31/09. However, the deadline is extended through 12/31/10 for certain longer-lived assets, transportation equipment, and aircraft. Bonus depreciation is computed after the Section 179 deduction, and there is no limitation on bonus depreciation. Therefore, for example, an entity that purchased qualifying property for \$1,250,000 would have no Section 179 deduction, but could elect bonus depreciation of \$625,000, which is 50% of the \$1,250,000 cost.

Cost remaining after the Section 179 deduction and bonus depreciation is subject to normal depreciation rules. To illustrate this, assume that in 2009 an entity purchases and places qualifying five-year property that cost \$600,000. Depreciation for 2009 would be \$460,000, consisting of the following:

Section 179 deduction	\$ 250,000
Bonus depreciation	175,000
Regular MACRS deduction	<u>35,000</u>
	<u>\$ 460,000</u>

The \$250,000 Section 179 deduction is the maximum allowable, and reduces the depreciable basis from \$600,000 to \$350,000. The 50% bonus depreciation allowance is applied to \$350,000, resulting in additional first-year depreciation of \$175,000. Basis of \$175,000 remains—\$350,000 – \$175,000 bonus depreciation—and is subject to normal depreciation rules. Applying the double declining balance method with a mid-year convention would yield additional depreciation of \$35,000 $[(\$175,000 \div 5 \text{ years}) \times 2 \times 1/2]$.

While the entity would be able to deduct \$460,000 of the \$600,000 cost in the year of acquisition for federal income tax reporting, the deduction would likely be smaller for state income tax reporting. Many states presently do not allow bonus depreciation, and some may impose a lower maximum on the Section 179 deduction.

For many entities, the effect of the increased Section 179 deduction will cause a significant difference between financial results under GAAP and the income tax basis. That difference may be described in the basis of accounting note through a description such as—

The basis differs from generally accepted accounting principles primarily because of tax provisions that enable the Company to immediately deduct a significant amount of the cost of its equipment purchases.

In addition to the changes to the Section 179 deduction rules, the 2004 Jobs Act reclassified qualified leasehold improvements and qualified restaurant property, placed in service before January 1, 2006, as 15-year property. The Emergency Economic Stabilization Act of 2008 (the 2008 Act) extended this treatment to qualified leasehold improvement property and qualified restaurant property placed in service before January 1, 2008. In addition, restaurant buildings can now be eligible for the 15-year depreciation rule (for qualified buildings placed in service in 2009.) Finally, the 2008 Act includes a new provision that allows 15-year straight-line depreciation of qualified retail improvement property placed in service in 2009.

Like-kind Exchanges and Involuntary Conversions. Final regulations are effective for like-kind exchanges and involuntary conversions of MACRS property for transactions after February 27, 2004. With minor exceptions, the final regulations are the same as the previous temporary regulations. The scope of the final regulations has been expanded to allow a taxpayer to elect to treat the sum of the exchanged basis and excess basis of the replacement property as MACRS property placed in service at the time of replacement even if the property given up was not being depreciated under MACRS. For example, a taxpayer that exchanges a machine depreciated under the unit of production method for a used machine may depreciate under MACRS the sum of the exchanged basis and excess basis of the used machine (replacement property) as a machine placed in service at the time of replacement.

Internal-use Computer Software Costs. Revenue Procedure 2000-50 (modified by Rev. Procs. 2004-11 and 2007-16) prescribes different tax treatments for the costs of internal-use computer software depending on whether the software is purchased, leased, or developed internally. Generally—

- a. Software may be purchased separately or along with hardware. The tax treatment of the cost of software that is purchased along with hardware depends on whether the cost of the software is specifically identified in the purchase documents, which Revenue Procedure 2000-50 refers to as being “separately stated.” The cost of software that is purchased separately, or that is purchased along with hardware but is separately stated, should be capitalized and amortized over three years using the straight-line method. The cost of software that is purchased along with hardware but is not separately stated should be capitalized as part of the hardware, which under MACRS is five-year property.
- b. Payments for software leases, which are typically written in the form of licenses, are deductible.
- c. Entities have the option of either deducting the costs of internally developing software or capitalizing the costs and amortizing them using the straight-line method over three years from the date the software is placed in service or five years from the date of completion of development.

SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* (FASB ASC 350-40), generally looks at the costs of software that entities purchase or develop for their own use in three stages—preliminary project, application development, and post-implementation/operation. For purposes of preparing GAAP statements, capitalization—

- a. Begin when the preliminary project stage is complete and management authorizes and commits to fund the project. In addition, it must be probable that the project will be completed and the software will perform its intended function.
- b. End when the project is substantially complete and ready for its intended use.

Under GAAP, the capitalized costs of internal-use software generally should be amortized on the straight-line basis over the estimated useful life of the software. Amortization should begin for each module or component of a

software project when the module or component is ready for its intended use; that is, after all substantial testing is completed for the module or component.

Costs of purchased software and leased software are likely to be accounted for the same in tax basis and GAAP financial statements, with the costs of purchased software capitalized and the cost of leased software charged to expense. However, tax basis financial statements might report as expenses certain costs of developing internal-use software that would be capitalized under GAAP. In addition, the amortization period in tax basis financial statements may be different than it would be under GAAP.

Website Development Costs. The IRS has not released any official guidance on the tax treatment of website development costs. Therefore, taxpayers can only look to existing guidance, such as Revenue Procedure 2000-50 on the treatment of the costs of computer software, and try to determine how their web development costs fit within those guidelines. In an unofficial, internal document issued in November 2000, the IRS Technical Advisor for Data Processing recommended that the IRS treat website development costs as software amortizable over a 36-month period under IRC Sec. 167(f), beginning with the day the website is placed on the Internet. EITF Issue No. 00-2, "Accounting for Website Development Costs," (FASB ASC 350-50-2) provides guidance on accounting for costs incurred in developing Internet websites in financial statements prepared using GAAP. Since that guidance generally requires expensing website development costs incurred during the planning stage and capitalizing costs incurred during the application development stage, the website's tax basis may differ from the amount required by GAAP.

Oil and Gas Properties. Valuing and depleting oil and gas properties using income tax requirements results in differences from measurements that would be required by GAAP (FASB ASC 932). The following are common differences:

- *Intangible Drilling Costs.* GAAP requires capitalizing intangible drilling costs and amortizing them against future operations. For income tax reporting purposes, however, entities may either charge those costs to operations when incurred or capitalize and amortize them to expense over seven years.
- *Depletion.* Income tax rules provide for computing depletion using statutory rates applied to gross income without regard to whether the basis has been exhausted. However, GAAP requires charging only the historical cost to operations, basically in proportion to production.

S corporations and partnerships cannot deduct depletion on oil and gas wells on their income tax returns. Instead, the individual shareholders and partners must determine the allowable amount to report on their individual income tax returns. However, some S corporation and partnership tax basis financial statements reflect depletion expense calculated by the entity without regard to the individual shareholders' or partners' limitations since the property's tax basis is reduced for depletion expense. Depletion expense can be reflected in an S corporation's or partnership's tax basis financial statements as long as the notes to the financial statements disclose the entity's accounting policy.

Business Start-up Costs. Start-up costs for income tax purposes commonly include costs incurred in connection with—

- investigating the creation or acquisition of an active trade or business.
- creating a new active trade or business.
- "preopening" activities that occur after the decision to start a business has been made but before the day on which the business actually begins.

Start-up costs generally are expensed when incurred under GAAP. SOP 98-5, *Reporting on the Costs of Start-Up Activities* (FASB ASC 720-15), provides guidance on the financial reporting of start-up costs and organization costs for GAAP purposes.)

A corporation can deduct up to \$5,000 of business start-up costs under IRC Sec. 195. The \$5,000 deduction is reduced dollar for dollar (but not below zero) for the cumulative start-up costs exceeding \$50,000. The remaining

start-up costs can be deducted ratably over a 15-year period (consistent with the amortization period for Section 197 intangibles) beginning with the month in which the active trade business begins.

Start-up Costs after September 8, 2008. The IRS issued temporary regulations that change the procedure for handling start-up costs. Under these new regulations, a taxpayer is no longer required to make a separate election statement to deduct start-up costs. Such an election is deemed to be automatically made for the tax year in which the taxpayer begins an active trade or business. The taxpayer can forgo the deemed election by clearly electing to capitalize its start-up expenditures on a timely filed return for the year the taxpayer begins business.

This change in procedure applies to start-up expenditures paid or incurred after September 8, 2008. However, taxpayers are allowed to apply these new regulations to start-up expenditures paid or incurred after October 22, 2004 if the statute of limitations has not expired for the tax year the election should have been made. Thus, a taxpayer who failed to make an election to deduct and amortize start-up costs incurred after October 22, 2004 for an open year can now file an amended return for that year, and subsequent years, to deduct and amortize these costs in accordance with IRC Sec. 195.

Start-up Costs prior to September 9, 2008. For start-up costs incurred prior to September 9, 2008, but after October 22, 2004, in a tax year for which a tax return has not yet been filed, a taxpayer does not have to make a separate election to deduct the start-up costs. If the taxpayer wishes to capitalize these expenditures, no separate election to do so should be required (although the regulations do not address this issue) since the costs were incurred prior to September 9, 2008, the effective date of the new regulations.

Changing Election. Once made, the election to deduct or capitalize start-up expenditures remains irrevocable as under prior rules. Therefore, if a taxpayer fails to take a deduction for start-up costs, but does not make a separate election to forgo the deduction of these costs, an incorrect accounting method is being used. If this situation is left uncorrected for two or more tax years, the taxpayer would have to request a change in accounting method under IRC Secs. 446 and 481(a) to go back and take a deduction for, or elect to capitalize the costs for, these prior years. If this change is never made, the deduction will be permanently lost, and the costs would have a zero basis on the balance sheet for income tax purposes. This same situation would occur if an expenditure that was deducted under IRC Sec. 162 was later determined to have been a start-up expenditure.

Organization Costs. Whenever a new C corporation, S corporation, or partnership is formed, certain costs associated with its creation are incurred. Organization costs are generally expensed when incurred under GAAP. (SOP 98-5, *Reporting on the Costs of Start-Up Activities* (FASB ASC 720-15), provides guidance on the financial reporting of start-up costs and organization costs for GAAP purposes.)

For income tax purposes, if organization costs were paid or incurred after October 22, 2004, IRC Sec. 248(a)(1) allows a corporation to elect to deduct up to \$5,000 in organization costs. The \$5,000 limitation is reduced dollar for dollar (but not below zero) by the amount of the corporation's organization costs that exceed \$50,000. The remainder of the corporation's organization costs are amortizable over 180 months (15 years) beginning with the month in which the corporation begins business.

Organizational Costs after September 8, 2008. The IRS issued temporary regulations that change the procedure for handling organizational expenses. Under these new regulations, a taxpayer is no longer required to make a separate election statement to deduct organizational costs in accordance with IRC Sec. 248(a). Such an election is deemed to be automatically made for the tax year in which the taxpayer begins business. The taxpayer can forgo the deemed election by clearly electing to capitalize its organizational expenditures on a timely filed return for the year the taxpayer begins business.

This change in procedure applies to organizational expenditures paid or incurred after September 8, 2008. However, taxpayers are allowed to apply these new regulations to organizational expenditures paid or incurred after October 22, 2004 if the statute of limitations has not expired for the tax year for which the election should have been made. Thus, a taxpayer who failed to make an election to deduct and amortize organizational expenditures incurred after October 22, 2004 in an open year can now file an amended return for that year, and subsequent years, to deduct and amortize these costs in accordance with IRC Sec. 248(a).

Organizational Costs prior to September 9, 2008. For organizational costs incurred prior to September 9, 2008, but after October 22, 2004, in a tax year for which a tax return has not yet been filed, no separate election will be

required to deduct and amortize the organizational costs in accordance with IRC Sec. 248(a). If the taxpayer decides to capitalize these expenditures, no separate election appears to be required (although the regulations do not address this issue) since the costs were incurred prior to September 9, 2008, the effective date of the regulations.

Changing Election. Once made, the election to deduct or capitalize organizational expenditures remains irrevocable as under prior rules. Therefore, if a taxpayer fails to take a deduction for organizational expenditures, but does not make a separate election to forgo the deduction, an incorrect accounting method is being used. The corporation should file amended returns to correct this error. If this situation is left uncorrected for two or more tax years, the taxpayer would have to request a change in accounting method under IRC Secs. 446 and 481(a) to go back and take a deduction for, or elect to capitalize the costs for, these prior years. If this change is never made, the deduction will be permanently lost, and the organizational costs would have a zero basis on the balance sheet for income tax purposes. This same situation would occur if an expenditure that was deducted under IRC Sec. 162 as an ordinary business expense was later determined to have been an organizational expense.

Syndication Costs. Syndication costs include all costs incurred in promoting or selling interests in a partnership. For income tax purposes, syndication costs must be capitalized as an asset. They may not be amortized, nor may they be deducted if the syndication effort is abandoned. Accounting for syndication costs for tax purposes differs from GAAP, which generally requires syndication fees to be offset against equity.

Intangible Assets. Entities may buy certain intangible assets, such as franchises, trademarks, trade names, patents, and copyrights. In addition, entities may have recorded goodwill resulting from the acquisition of a business. For tax purposes, intangible assets (including goodwill) acquired after August 10, 1993 (or July 25, 1991 if elected) are referred to as IRC Section 197 intangibles and may be amortized over a 15-year period beginning with the month the assets were acquired. The 15-year period applies regardless of the intangible asset's actual useful life.

An exception to the tax requirements discussed in the preceding paragraph applies to franchises, trademarks, and trade names acquired under contingent serial payment arrangements (including licenses, permits, or rights granted by governmental units or agencies). If the payments the entity makes are (a) contingent on the productivity, use, or disposition of the asset, (b) payable at least annually for the full period the entity has the right to use the asset, and (c) substantially equal in amount or determined under a fixed formula, the asset is not amortizable under IRC Section 197. Instead, it is deductible currently by the entity. (FASB ASC 350-20-35-1)

GAAP requirements depend upon whether an intangible asset is goodwill, or if not, whether it has a finite or indefinite life. SFAS No. 142, *Goodwill and Other Intangible Assets*, prohibits the amortization of goodwill and requires that goodwill be tested for impairment at least annually. Other intangible assets that have an indefinite useful life should not be amortized, but rather should be subject to an impairment test similar to that performed for goodwill. Other intangible assets that have a finite useful life should be amortized over the asset's estimated useful life, with the carrying amount reviewed for impairment generally only when events or changes in circumstances indicate that it may not be recoverable. Amortization should be calculated using the straight-line method unless another method better reflects the pattern of consumption of the economic benefits of the intangible asset.

Liabilities. Generally, no expenses may be accrued and deductions taken for tax purposes until (a) all events necessary to establish the fact of liability or deduction have occurred, (b) the amount of the liability or deduction is determinable with reasonable accuracy, and (c) economic performance has occurred. In many cases, that will result in liabilities being accrued in the same period they would for GAAP, which requires they be accrued when it is probable they have been incurred and their amounts can be reasonably estimated. In some cases, it will not. Different rules may apply to specific transactions, and the authors recommend federal income tax laws be consulted before accruing and deducting expenses in tax basis financial statements.

Asset Retirement Obligations. SFAS No. 143, *Accounting for Asset Retirement Obligations* (FASB ASC 410-20-25-4), requires that entities recognize the fair value of a legal obligation for asset retirement when a reasonable estimate of fair value can be made. In subsequent periods, the liability should be adjusted for interest accretion and for changes in estimates. The recognition of a liability should be accompanied by an increase in the carrying amount of the related asset, and the resulting carrying amount should then be subjected to the normal

impairment tests required by generally accepted accounting principles. Examples of legal asset retirement obligations for small and midsize nonpublic entities are—

- a. A legal requirement for the operator of a rock quarry to restore the land to its original condition at the end of a prescribed period.
- b. A provision of a long-term land lease that requires the lessee to demolish all structures on the land and restore the land to its original condition when the lease expires.

FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations—an interpretation of FASB Statement No. 143* (FASB ASC 410-20-20), clarifies that the term *conditional asset retirement obligation* in SFAS No. 143 refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be controlled by the entity. Even though there is uncertainty about the timing or method of settlement, the obligation for retiring the asset is unconditional and the entity is therefore required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. The Interpretation clarifies when an entity would have enough information to reasonably estimate that obligation.

Environmental Cleanup Costs. Federal and state laws impose legal obligations on owners of environmentally damaged properties, and those obligations can be very costly. Examples of costs incurred as a result of those obligations, which are often referred to as environmental cleanup costs or environmental remediation costs, are soil removal and disposal costs, fines, engineering fees, and legal fees. GAAP and tax reporting considerations generally fall into two categories—when to recognize the costs and whether to capitalize the costs recognized or charge them to expenses. In addition, there are certain disclosure considerations.

When to Recognize the Costs. Generally, environmental cleanup costs are likely to be recognized sooner in GAAP financial statements than in income tax basis statements. Revenue Ruling 94-38 generally requires following the economic performance rules of Section 461(h) of the Internal Revenue Code to determine when environmental cleanup costs are recognized. In tax basis financial statements, therefore, the authors believe that environmental cleanup costs ordinarily should not be recognized until paid.

SOP 96-1, *Environmental Remediation Liabilities* (FASB ASC 410-30), provides guidance for determining when to recognize environmental cleanup costs in GAAP financial statements. Generally, the entity should recognize a liability for environmental cleanup costs, which the SOP referred to as an environmental remediation liability, when it is probable that a liability for those costs has been incurred and when the amount of the liability can be reasonably estimated. A liability is probable when—

- a. It has been asserted, or it is probable that it will be asserted, through litigation, claim, or regulatory assessment, that the entity is responsible for participating in an environmental remediation process as a result of a past event.
- b. It is probable that the result of the litigation, claim, or assessment will be unfavorable and the entity will be held responsible.

Whether to Capitalize the Costs Recognized or Charge Them to Expenses. Certain costs that GAAP requires capitalizing may be deductible for tax reporting, and, as a result, an asset that would be reported under GAAP would not be reported in tax basis statements.

Revenue Ruling 94-38 generally requires following the guidance in Section 263 of the Internal Revenue Code in determining whether environmental cleanup costs should be capitalized. Applying the requirements of Section 263 generally results in the same accounting treatment for costs recognized in tax basis financial statements as under GAAP. As a rule of thumb, if the costs add value to the asset, Section 263 requires capitalizing them; otherwise, they are deductible. For example, under Revenue Ruling 94-38 cleanup costs of property that an entity contaminated through business operations generally are deductible if the costs are incurred to restore the property to its original condition at the time of acquisition. If the costs increase the property's value or prolong its useful life, they should be capitalized in tax basis statements (and under GAAP).

Revenue Ruling 2004-18 subsequently clarified that amounts incurred to clean up land that a taxpayer contaminated with hazardous waste by the operation of a manufacturing plant must be included in inventory costs under IRC Section 263A. In Rev. Rul. 2005-42, the IRS ruled that remediation costs incurred to clean up land contaminated by the taxpayer's manufacturing activities are properly allocable under IRC Sec. 263A to inventory produced during the tax year the costs are incurred. The costs must be allocated to current year production whether the taxpayer (a) manufactures a different inventoriable item than was produced when the contamination occurred, (b) has stopped using the contaminated site for manufacturing, or (c) incurs the costs to clean up a site separate from the contaminated site.

Despite the general rules for whether environmental cleanup costs should be capitalized or are deductible, Section 198 of the Internal Revenue Code provides an election to deduct qualifying costs that would otherwise be capitalized and are incurred in connection with qualifying sites. Accordingly, costs deducted under Section 198 would be recognized as an expense in tax basis statements but would be charged to an asset in GAAP statements.

Disclosure Considerations. Even though a liability for environmental cleanup costs is not recognized in tax basis statements, disclosure of the contingency for environmental cleanup costs may be necessary to keep the statements from being misleading.

Accrued Benefits. Entities may provide various types of benefits to their employees, including vacation pay, bonuses, retirement plans, and unfunded deferred compensation arrangements. The requirements for accruing those benefits in tax basis financial statements are as follows:

- **Accrued Vacation Pay and Bonuses.** Generally, entities using the accrual basis for tax reporting purposes may deduct vacation pay and bonuses that are paid within the tax year or vested at the end of the tax year and paid within 2½ months following the end of the tax year. Amounts paid after 2½ months following the end of the tax year are deductible in the tax year in which they are actually paid. (Vacation pay and bonuses for shareholders cannot be deducted until paid and should not be accrued, however, under the general notion of expenses with related cash basis taxpayers.) Under GAAP, vacation pay and bonuses related to the current year should be accrued regardless of when they will be paid.
- **Accrued Retirement Plan Contributions.** Entities are allowed a deduction for tax purposes in the current year for contributions made to a qualified retirement plan during the current tax year. A deduction for the current year is also allowed if the contribution is made on or before the due date of the current year's return, including any extensions. Federal income tax laws place limitations on the amount that can be deducted. Under GAAP, the amount of the contribution accrued generally would be determined in accordance with SFAS No. 87, *Employers' Accounting for Pensions*, as amended by SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)* (FASB ASC 715).
- **Unfunded Deferred Compensation Arrangements.** Generally, entities are allowed a deduction for income tax reporting purposes related to unfunded deferred compensation arrangements when employees include the deferred amounts in their income (usually when the amounts are paid). Under GAAP, those benefits would be recorded in the period in which each employee becomes entitled to the benefits, which generally is when future payment becomes probable.

Equity or Capital. Depending on the type of entity, the equity or capital section on the tax basis balance sheet could include common stock, preferred stock, additional paid-in capital, retained earnings, treasury stock, members' equity, or partners' or proprietor's capital. In addition, if liabilities exceed assets, a negative equity or capital balance will be reported.

The following presentations of equity or capital, and the changes in those amounts, in the financial statements of C corporations, S corporations, partnerships, limited liability companies, and sole proprietorships are best practices:

- a. **Negative Equity or Capital.** It is generally believed that the terms "equity" and "capital" should not be used if a negative equity or capital balance is reported on the tax basis balance sheet. Accordingly, the use of captions such as "deficiency in assets" or "stockholders' (partners') deficit" (if all periods presented report

negative equity) or "stockholders' equity (deficiency in assets)" or "stockholders' (partners') equity (deficit)" (if only one period of comparative statements reports negative equity) generally is recommended.

- b. *C Corporations.* Usually, each class of stock is disclosed on the face of the tax basis balance sheet (in the order of priority of liquidation) rather than in a note to the financial statements. The terms used to describe classes of stock should usually be the legal title of the stock issue, for example, capital stock, common stock, or some other title. The following information is typically disclosed for each class of stock:

- (1) Title of issue, for example, common stock or Class A common stock
- (2) Par value (or stated value) per share
- (3) Shares authorized
- (4) Shares issued

A descriptive caption, such as "additional paid-in capital" or "capital in excess of par or stated value" is usually presented immediately following preferred and common stock. "Retained earnings," which represents undistributed earnings of the company, usually follows additional paid-in capital on the income tax basis balance sheet.

If the company has acquired shares of its stock and is holding them as treasury stock, they should be included in the disclosure of shares issued. In addition, the title of the issue, number of shares held in treasury, carrying basis, and restrictions of state laws, if any, are traditionally disclosed.

Most of the disclosures are generally provided through expansion of the captions on the tax basis balance sheet.

- c. *S Corporations.* The presentation of the stockholders' equity section of the tax basis balance sheet of an S corporation is basically the same as for a C corporation. However, federal income tax laws define different components of retained earnings of an S corporation, such as the accumulated adjustments account, previously taxed income, and accumulated earnings and profits. The authors believe the most common presentation on tax basis balance sheets is to report a single retained earnings amount rather than presenting those components of retained earnings on the face of the statement. However, some accountants believe disclosing the individual components of retained earnings of an S corporation and reporting changes in those components provides the reader of the financial statements with useful information. Other accountants believe that is not a meaningful presentation since interested users can compute that information from the shareholders' Schedule K-1s. If information about the different components of retained earnings is provided, it can be disclosed in the notes to the financial statements or in a separate statement of retained earnings.
- d. *Partnerships.* The equity section of the tax basis balance sheet of a partnership usually should be labeled "Partners' Capital." Some accountants believe reporting changes in the individual equity accounts of the partners provides the reader of the financial statements with useful information. Others, however, believe that is not a meaningful presentation since interested users can obtain that information from the partners' Schedule K-1s. In addition, it may be desirable in some situations to disclose the capital accounts of the classes of partners.
- e. *Limited Liability Companies.* Since the owners of a limited liability company are referred to as members, Practice Bulletin 14 (PB 14), *Accounting and Reporting By Limited Liability Companies and Limited Liability Partnerships* (FASB ASC 272-10-45-3), states that the equity section of the balance sheet should be labeled "members' equity." Following the guidance in Interpretation 14 of SAS No. 62 (AU 9623.90-.95), tax basis financial statements should also follow the presentation requirements of PB 14 (FASB ASC 272-10-45) or communicate the substance of those requirements. Accordingly, the authors believe income tax basis financial statements should also use the caption "members' equity." Ownership interests may be represented by membership certificates or shares. For example, an LLC may issue Class I shares with unlimited voting rights and Class II shares with only limited rights and privileges. Different classes of shares

may also have different rights as to the distribution of assets upon dissolution of the company. If ownership interests are represented by membership certificates or shares, the equity section of the tax basis balance sheet will resemble that of a corporation. If ownership interests are not represented by membership certificates or shares, the equity section of the tax basis balance sheet will resemble that of a partnership.

PB 14 (FASB ASC 272-10-45-3) states the components of members' equity may be presented on the face of the balance sheet or in the notes to the financial statements. PB 14 (FASB ASC 272-10-45-4) also states that if a member's equity account is less than zero, a deficit should be reported even though the member's liability may be limited.

- f. *Sole Proprietorships.* The equity section of the tax basis balance sheet of a sole proprietorship usually should be labeled "Proprietor's Capital." Unlike corporations, no distinction is usually made on the tax basis balance sheet between capital contributed, beginning capital, and retained earnings. However, when both a tax basis balance sheet and income statement are presented, the authors believe sole proprietorships should disclose the changes in proprietor's capital (i.e., contributions to capital, earnings, and drawings). In many cases, those changes can be appropriately disclosed by presenting a combined statement of revenues, expenses, and changes in proprietor's capital. In other cases, accountants may choose to disclose those changes in the proprietor's capital section on the tax basis balance sheet or in a separate statement of changes in proprietor's capital.

Specific Measurement and Presentation Considerations—Revenues and Expenses

Revenues. Generally, revenue recognition does not differ between GAAP and the accrual method used for income tax reporting purposes. However, special rules may apply to the following transactions:

- *Long-term Contracts.* Generally, entities (including manufacturers and construction contractors) must report earnings from long-term contracts for tax purposes using the percentage-of-completion method. Entities with average annual gross receipts of \$10 million or less for the three taxable years preceding the contract year and that perform only real property contracts that will be completed within two years or manufacturing contracts that will be completed within one year may use the completed-contract method, however. Current tax law also exempts certain home construction contracts. GAAP requires income from most long-term construction contracts to be recognized under the percentage-of-completion method. The GAAP treatment of home construction contracts depends on whether the builder or the buyer owns the underlying land.
- *Advance Payments.* Generally, payments received in advance by accrual basis entities should be recognized upon receipt for income tax reporting purposes provided there is no restriction on their use—even if the payments are returnable when some specified event happens. Exceptions to that general rule exist for
 - a. Advance payments received for services or certain goods to be delivered in the next tax year. Revenue Procedure 2004-34 generally requires an accrual basis taxpayer using the deferral method to include advance payments in income the earlier of the tax year in which it is included in the taxpayer's applicable financial statement, or the tax year following the year of receipt. Advance payments qualifying for deferral include:
 - Services.
 - The sale of goods [unless the taxpayer uses a deferral method under Reg. 1.451-5(b)(1)(ii)].
 - Intellectual property (including copyrights, patents, trademarks, service marks, trade names, and similar intangible property rights such as franchise rights and arena naming rights).
 - The occupancy or use of property if ancillary to the provision of services (such as a hotel room, booth space at a trade show, or campsite space at a mobile home park).
 - The sale, lease, or license of computer software.

- Guaranty or warranty contracts ancillary to the items described in the above bulleted items.
 - Online and tangible subscriptions (unless Section 455 prepaid subscription income provisions apply).
 - Memberships in an organization (unless Section 456 prepaid membership dues provisions apply).
 - Any combination of the items described in the above bulleted items.
- b. Prepayments that may be refunded for services, goods, or deposits over which the entity does not have complete control or dominion upon receipt (for example, deposits received by a utility company from uncreditworthy customers that must be returned when the customers demonstrate creditworthiness). In those cases, the advance payments may be excluded from income until the year in which the services are actually performed (or the entity gains complete control over the payments). Under GAAP, advance payments generally are recorded as deferred revenue and recognized when earned.
- *Installment Sales.* For income tax reporting purposes, profits from installment sales may be recognized entirely in the year of the sale or recognized under the installment method as sales proceeds are collected. If the entity elects to use the installment method, best practices indicate that the deferred gain should be offset against the related receivable. Under GAAP, gross profit on installment sales generally is recognized in the year the assets are sold and a receivable is recorded for the sales proceeds to be collected in future years.
 - *Sales Returns.* Entities sometimes sell their products with the understanding that customers who return products within a prescribed time will receive a full or partial refund of the selling price. While sales returns should be reported as a reduction of sales for both income tax basis and GAAP financial statements, the amount of returns recognized may be different. For income tax reporting purposes, sales returns generally are recognized in the period they are realized, but GAAP generally requires recognizing probable returns in the period the sale is recognized, either through a valuation allowance for trade receivables or liability. Accordingly—
 - a. Sales returns may be recognized sooner in GAAP financial statements than in tax basis statements.
 - b. A valuation allowance or liability that would be recognized in GAAP financial statements would not be recognized in tax basis statements.

Cost of Goods Sold. The income tax returns for C corporations, S corporations, and partnerships each include a Schedule A to the tax return that calculates the amount of cost of goods sold by reconciling beginning and ending inventory amounts. In most areas, the recognition of cost of goods sold does not differ between GAAP and the accrual method of accounting used for income tax reporting. However, one area that may differ is the timing of recognition of IRC Section 263A costs related to inventory.

Cost of goods sold is often shown as one caption on the statement of revenues and expenses, as the following example illustrates:

SALES	\$	833,712
COST OF GOODS SOLD		<u>720,263</u>
GROSS PROFIT		113,449

However, some entities choose to show a rollforward of cost of goods sold on the statement of revenues and expenses similar to that reflected on Schedule A of the tax return. The following is an example presentation if the entity presents a rollforward of cost of goods sold:

SALES	\$	833,712
COST OF GOODS SOLD		720,263

Beginning Inventory	68,414
Purchases	<u>787,764</u>
Total available for sale	856,178
Ending inventory	<u>(135,915)</u>
	<u>720,263</u>
GROSS PROFIT	113,449

Deduction for Production Activities Conducted in the United States. The domestic production activities deduction is a deduction for income attributable to domestic production activities. In general, this tax deduction applies to any business that manufactures, produces, grows, or extracts qualifying production property within the United States. It also applies to services related to construction in the United States and applies to engineering and architectural services related to construction.

The deduction equals 6% for 2009 (9% for tax years beginning after 2009) of the lesser of:

- the qualified production activities income (QPAI) of the taxpayer for the tax year, or
- taxable income, determined without this deduction.

The amount of the deduction allowable for any tax year may not exceed 50% of the W-2 wages of the employer for the year. For tax years beginning after May 17, 2006, W-2 wages are limited to amounts properly allocable to domestic production gross receipts (DPGR). After using one of the three options under Rev. Proc. 2006-47, to compute W-2 wages, the rules contained in Reg. 1.199-2 are used to allocate these wages to DPGR. Taxpayers can use any reasonable method or specified safe harbor methods to allocate wages between domestic production gross receipts and nondomestic production gross receipts.

While the domestic producer deduction was (theoretically) intended primarily for manufacturers, the deduction is generally based on qualified production activities, and the definition of those activities is very broad. Many taxpayers will qualify for the deduction, including (but not limited to) those engaged in the following industries:

- sales of personal property, if the property is manufactured, produced, grown, or extracted by the taxpayer in the U.S.;
- traditional manufacturing of tangible personal property;
- construction in the U.S.;
- civil engineering and architectural services for U.S. construction projects;
- production (but not transmission or distribution) of electricity, gas, and potable water;
- software production;
- film and videotape production, renting, and licensing;
- farming (i.e., growing and selling agricultural products and food); and
- processing of agricultural products and food (but not the sale of food and beverages prepared by the taxpayer at a retail establishment).

When calculating this deduction, the following definitions apply:

- Qualified production activities income* is defined as the taxpayer's domestic production gross receipts for the year reduced by the cost of goods sold and other deductions, expenses and losses directly allocable to the receipts.

- *Domestic production gross receipts* refers to gross receipts derived from any lease, rental, license, sale, or other disposition of qualified production property that was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the U.S. Property will be treated as manufactured by the taxpayer "in significant part" if (1) the taxpayer's direct labor and overhead for the manufacture, production, growth, and extraction of the qualified production property within the U.S. account for 20% or more of the taxpayer's cost of goods sold, or in a transaction without cost of goods sold (such as a lease, rental, or license) account for 20% or more of the taxpayer's unadjusted depreciable basis of the qualified production property. (For taxpayers subject to the UNICAP rules, overhead includes all costs required to be capitalized under IRC Sec. 263A except for direct materials and direct labor.) A taxpayer engaging in only packaging, repackaging, labeling, and minor assembly operations must disregard the substantial in nature and safe harbor tests, or (2) based on all of the taxpayer's facts and circumstances, the manufacturing, production, growth, or extraction activity performed by the taxpayer in the U.S. is substantial in nature. This also includes income from a qualified film produced by the taxpayer, or income from electricity, natural gas, or potable water produced in the U.S. Furthermore, domestic production gross receipts include construction performed in the U.S., or engineering or architectural services performed in the U.S. or construction projects in the U.S. However, the term does not include gross receipts derived from the sale of food and beverages prepared by the taxpayer at a retail establishment, or the transmission or distribution of electricity, natural gas, or potable water.
- *Qualified production property* includes tangible personal property, any computer software, and sound recordings. The fact that property is personal property or tangible property under local law is not controlling. Conversely, property may be tangible personal property for Section 199 purposes even if local law considers it a fixture and, thus, real property. Tangible personal property does not include land, buildings, or inherently permanent structures.

Machinery, printing presses, transportation equipment, office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and signs that are contained in or attached to a building are tangible property. Furthermore, property that is in the nature of machinery, other than structural components of a building, is tangible personal property even though located outside a building. For example, a gasoline pump, hydraulic car lift, or automatic vending machine, although attached to the ground outside, is tangible personal property.

The deduction is allowed when computing alternative minimum taxable income (AMTI). However, when computing AMTI, the deduction will be determined by reference to the lesser of the qualified production activities income (as determined for the regular tax) or the AMTI, regardless of the domestic producer deduction. The deduction is not allowed in computing self-employment tax.

The domestic producer deduction will be deductible when computing a corporation's adjusted current earnings (ACE), even though it is not deductible in computing the corporation's earnings and profits for regular tax purposes.

The domestic producer deduction regulations are complex and further guidance remains to be issued. This section only discusses the key rules and terms for applying the deduction. For a detailed discussion of the domestic producer deduction, see *PPC's Tax Planning Guide—Closely Held Corporations*, *PPC's Specialized Industry Tax Guide*, and *PPC's 1120 Deskbook*.

Rent Income and Rent Expense. For income tax reporting purposes, accrual basis lessors usually recognize rent income under operating leases when earned, and accrual basis lessees generally recognize rent expense under operating leases when payments are due. For example, assume that a two-year lease agreement requires the tenant to make monthly payments of \$2,000, but requires no payments for the first three months to provide an incentive for the tenant to rent the space. For tax reporting purposes, the lessor would report no income from the lease for the first three months, and the lessee would deduct no rent expense during the period. Under GAAP, lessors and lessees are required to recognize rent under noncancelable operating leases on a straight-line method over the period the lessee controls the use of the leased property. Accordingly, rent expected under the noncancelable period is computed and recognized evenly over the lease term.

For income tax reporting purposes, IRC Sec. 467 may require a different tax treatment in situations such as when developers give prospective tenants rent concessions to lease up a building. Although these concessions can take many forms, the two most common are free rent and stepped rent.

- **Free Rent.** Particularly in distressed real estate markets, developers may offer new tenants “rent holidays.” For example, to sign a tenant to a 10-year lease, the developer may offer a lease that does not require the tenant to pay rent until the first day of the third year. These types of rental arrangements are potentially governed by IRC Sec. 467.

IRC Sec. 467 provides two sets of rules: the “deferred rent” rules and the “rent leveling” rules. Free rents are regulated under the deferred rent rules. The deferred rent rules require the landlord and the tenant to impute interest on any deferred rent payment. These rules were originally designed to prevent accrual-basis taxpayers from deducting unpaid rents to cash-basis landlords. However, in the case of free rent, there is an important exception in IRC Sec. 467(b)(5). This exception provides that the IRC Sec. 467 rules do not apply to a “reasonable rent holiday.”

- **Stepped Rent.** IRC Sec. 467 can also apply when leases provide for “stepped rent.” Stepped rent describes rental payments that generally increase or decrease over the lease term. For example, a 10-year lease may require the tenant to pay \$2,000 per month for the first two years, \$2,500 per month for the next three years, and \$3,500 per month for the remaining five years. Leases like these are particularly attractive to fledgling businesses that expect revenues to increase dramatically over the first few years of operations. Leases that include provisions for stepped rents are generally subject to the rent leveling rules under IRC Sec. 467.

The rent leveling rules provide that, if a tenant makes rent payments that are not excluded and constant in amount, the IRS will require both the landlord and the tenant to take the total amount of rent to be paid into account ratably over the lease term. However, the rules of IRC Sec. 467 do not apply to stepped rent situations unless a tax-avoidance motive is present. Since free rent and stepped rent arrangements almost universally result from market conditions rather than tax-avoidance motives, practitioners should view the Section 467 rules with great skepticism. It is rare the rules of this section actually apply—except in related-party or true rent deferral situations. For a detailed discussion of the tax consequences of Section 467 rental arrangements, please see *PPC's Guide to Real Estate Taxation*.

Tax-exempt Revenues. Certain revenues are not taxable for income tax purposes. For example, interest on state and municipal obligations is tax-exempt. In addition, C corporations are allowed a deduction, referred to as the dividends received deduction, for a portion of dividends received from U.S. corporations. (For purposes of preparing the C corporation's tax return, 100% of the dividends are included in gross income, with a deduction from gross income being allowed for the dividends received deduction.)

Nondeductible Expenses. Current tax law limits the deductibility of certain expenses. The following are examples of nondeductible expenses:

- Premiums paid for life insurance on officers or employees if the entity is the beneficiary
- Penalties and fines
- Interest incurred to purchase tax-exempt securities
- Nondeductible portion of meals and entertainment expenses
- Club dues

Tax-exempt Revenues and Nondeductible Expenses—There Are No Temporary Differences. Permanent differences, are the only differences between revenues and expenses recognized in an entity's tax basis statements and its income and deductions in determining taxable income for the period. There are no temporary differences in tax basis statements. That is because SFAS No. 109, *Accounting for Income Taxes*, defines the term *temporary difference* as a “difference between the tax basis of an asset or liability computed pursuant to the requirements in Subtopic 740-10 for tax positions, and its reported amount in the financial statements that will result in taxable or

deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively” (FASB ASC 740-10-20). In tax basis statements, assets and liabilities are reported at their tax basis. Accordingly, there can be no difference between the tax basis of an asset or liability and its reported amount in the financial statements, and the condition prescribed by the definition of the term *temporary difference* cannot be met.

To illustrate, assume that in its GAAP statements an entity using the accrual basis to determine taxable income recognizes a liability for accrued interest due to a related party. The related party uses the cash basis to determine taxable income, and, for the reasons discussed in paragraph , the interest is not deductible until the entity pays it. The liability for accrued interest recognized in the entity's GAAP statements therefore has no tax basis and is a deductible temporary difference between amounts recognized in the GAAP statements and the income tax returns. However, since it has no tax basis, best practices indicate that neither the liability nor the related accrued expense would be recognized in tax basis statements for the period. Instead, the expense would be recognized in tax basis statements for the period when the entity pays the interest. In other words, the expense would be recognized in tax basis statements for the period in which it is deducted.

Guaranteed Payments to Partners. A partner cannot be both an employee and a member of the same partnership. Therefore, a partnership cannot pay a “salary” to a partner with the same tax consequences as compensation paid to a nonpartner employee. However, the IRC gives partners and partnerships a method, through the use of guaranteed payments, to achieve almost the same tax treatment as that accorded salary payments. A “guaranteed payment” is a distribution to a partner in his or her capacity as a partner for performing services or for the use of capital. The guaranteed payments are generally deductible by the partnership. Some accountants believe any guaranteed payments to partners should be separately disclosed in the financial statements, either as a separate line on the statement of revenues and expenses or through disclosure in the notes to the financial statements. However, since payments in lieu of compensation are excluded from the requirements of SFAS No. 57 (FASB ASC 850-10), they are not required to be disclosed in tax basis statements.

Income Taxes. Later in this lesson, the presentation of income taxes in tax basis financial statements of C corporations is discussed. Income from S corporations, partnerships, limited liability companies, and sole proprietorships is taxed to the individual owners rather than the entities. Therefore, the financial statements of those entities should not reflect any federal income tax expense or related liability.

ACCOUNTING FOR FEDERAL INCOME TAX PURPOSES—CASH METHOD

The cash method of accounting for income tax reporting is similar to the accrual basis of accounting for income tax reporting except the timing of income and expense recognition differs. That is, assets are capitalized and depreciated (if applicable) and revenues and expenses are measured the same as under the accrual basis, but they generally are not recognized in the financial statements until cash is actually received or paid. Specifically, under the cash method of accounting for income tax reporting, income generally is recorded when it is actually or constructively received and expenses generally are recognized when they are actually paid or property is transferred. In some cases, however, expenses are deducted in a different period to more clearly reflect taxable income (for example, depreciation expense).

Using the cash method often allows entities to defer the recognition of income and accelerate the recognition of expenses to minimize taxable income for the year. Alternatively, if the entities want to report more taxable income for the year, income often can be accelerated and deductions deferred.

Specific Measurement and Presentation Considerations

The following paragraphs discuss certain exceptions to the general rule that transactions are not recognized until cash is received or paid.

Inventory. As discussed previously, federal income tax laws require the use of inventories whenever necessary to clearly determine income, which is usually the case whenever the production, purchase, or sale of merchandise is an income-producing factor. Thus, even if entities use the cash basis as the overall method of accounting, tax laws will usually require them to use the accrual method to account for purchases and sales if they have inventories.

Prepaid Expenses. Generally, entities using the cash method of accounting may currently deduct the full amount of expenses paid in advance (such as rent and insurance) if the period the payment applies to does not extend

beyond the close of the following tax year. However, the IRC provides that entities using the cash method can deduct interest only as it accrues over the term of the note payable. Therefore, entities using the cash method cannot deduct prepaid interest that relates to years following the current tax year. Any prepaid interest would therefore be reflected as a prepaid expense on the tax basis balance sheet.

Organization Costs. Organizational costs can be amortized over a period of 15 years for costs incurred after the enactment of the 2004 Jobs Act. This applies to all organization costs incurred before the end of the year the entity begins business. However, a cash basis taxpayer cannot actually begin to amortize the costs until they are paid.

Accrued Retirement Plan Contributions. Cash basis entities are allowed a current year deduction for income tax purposes for contributions made to a qualified retirement plan during the year. A deduction for the current year is also allowed if the contribution is made on or before the due date of the current year's return, including any extensions. Federal income tax laws place limitations on the amount that can be deducted.

Construction Contracts. The cash method recognizes income based on payments received or constructively received and deductions based on disbursements. If payments are received subject to restrictions (e.g., because payments are received in advance of performing certain functions), they may be excluded from income. In addition, if payments can be received, they may be required to be included in income. The contractor may not use the cash method if it has significant inventories or is required to maintain inventories. In addition, the contractor may not use the cash method if it significantly distorts income. Thus, a contractor should not have significant unrecorded contract receivables or payables.

Rent Income. If the cash method is used for income tax purposes, tax basis financial statements should recognize rental income as it is received.

Bad Debt Deduction. A cash basis entity may not claim a bad debt deduction unless it had previously included that amount in income or it incurs an actual cash loss. To incur an actual cash loss, the entity must have transferred money or other property to another party.

Income Taxes. The presentation of income taxes in tax basis financial statements of C corporations is discussed later in this lesson. Income from S corporations, partnerships, limited liability companies, and sole proprietorships is taxed to the individual owners rather than the entities. Therefore, the financial statements of those entities should not reflect any federal income tax expense or related liability.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

8. Amber Enterprises presents its financial statements using the accrual method of accounting for federal income tax purposes. When does Amber Enterprises report income?
 - a. When the income is actually received.
 - b. In the year earned.
9. Which of the following expenses is deductible under the recurring item exception?
 - a. Liabilities incurred by a tax shelter.
 - b. Workers' compensation claims.
 - c. Awards and jackpots.
 - d. Torts.
10. Valuing depreciating property and equipment using income tax requirements often results in differences from measurements that would be required by GAAP. Which of the following is not considered one of the differences?
 - a. Requirements for capitalizing leases that is less flexible than GAAP.
 - b. Using the purchase method to account for stock acquisition of a company.
 - c. Assets valued at the owner's tax basis that are contributed by an owner.
11. Which of the following statements regarding internal-use computer software costs is most accurate?
 - a. The cost of internal-use software should be deducted.
 - b. Software may be purchased separately or along with hardware.
 - c. Software lease payments are not deductible.
 - d. Purchased and leased software costs generally are not accounted for the same in tax basis and GAAP financial statements.
12. Louis and Sons Jewelry (J&S) incurs business start-up costs in 2009. How will the company deal with the start-up costs under the income tax basis of accounting?
 - a. The company will capitalize and amortize the start-up costs over three years using the straight-line method.
 - b. J&S can charge the start-up costs to operations when incurred or capitalize and expense them over five years.
 - c. J&S can deduct \$5,000, reduced by the amount which the start-up costs exceed \$50,000.
13. Which of the following costs includes all costs incurred in selling interests in a partnership?
 - a. Organizational.
 - b. Syndication.

14. Which of the following statements regarding environmental cleanup costs is most accurate?
- a. State and federal laws impose costly legal obligations on owners of environmentally damaged properties.
 - b. Environmentally cleanup costs generally are recognized sooner in income tax statements than in GAAP financial statements.
 - c. Revenue Ruling 94-38 provides guidance for determining when to recognize environmental cleanup costs in GAAP financial statements.
 - d. Costs deducted under Section 198 are recognized as an expense in GAAP statements.
15. Which of the following would be appropriate for the financial statements of a C corporation using the accrual method for federal income tax purposes?
- a. The equity section of the balance sheet should have the label "member's equity."
 - b. A single retained earnings amount should be reported on the tax basis balance sheet.
 - c. Each class of stock should be disclosed on the face of the tax basis balance sheet.
 - d. Negative equity or capital should be reported on the tax basis balance sheet.
16. Select from the following answer choices the one that matches the definition below.
Definition: A 10-year lease may require the tenant to pay \$2,000 per month for the first two years, \$2,500 per month for the next three years, and \$3,500 per month for the remaining five years.
- a. Deferred rent rule.
 - b. Free rent.
 - c. Stepped rent.
17. Which of the following is an example of a nondeductible expense?
- a. Meals and entertainment expenses.
 - b. Penalties and fines.
 - c. Life insurance premiums.
18. Coastal Construction (CC) wants to present its financial statements using the cash method of accounting for income tax purposes. Which of the following will preclude CC from making that choice?
- a. CC maintains significant inventories.
 - b. CC does not have any unrecorded contract receivables or payables.
 - c. CC recognizes deductions based on disbursements.
 - d. CC receives payments subject to restriction.

19. Select the scenario that best describes a company using the cash method of accounting for income tax purposes?
- a. Shelton-Morgan amortizes organization costs over 60 months, starting with the month invoices for the costs were received.
 - b. CalendarCo takes a bad debt deduction for cash that it transferred to LLT Company before LLT went bankrupt.
 - c. Swift Production, LLC, recognizes federal income tax expenses and related liabilities on its financial statements.
 - d. Real Estate Management, Inc., recognizes rental income on its financial statements when the rent is due.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

8. Amber Enterprises presents its financial statements using the accrual method of accounting for federal income tax purposes. When does Amber Enterprises report income? **(Page 136)**
- a. When the income is actually received. [This answer is incorrect. This answer choice reflects the definition of cash accounting.]
 - b. In the year earned. [This answer is correct. Entities that use the accrual method will report income when the amount can be determined with reasonable accuracy and the right to receive the income has occurred.]**
9. Which of the following expenses is deductible under the recurring item exception? **(Page 136)**
- a. Liabilities incurred by a tax shelter. [This answer is incorrect. This expense is not eligible for the recurring item exception.]
 - b. Workers' compensation claims. [This answer is incorrect. Workers' compensation claims are not eligible for the recurring item exception.]
 - c. Awards and jackpots. [This answer is correct. Awards, prizes, and jackpots are all eligible for the recurring item exception.]**
 - d. Torts. [This answer is incorrect. Torts are not eligible for the recurring item exception.]
10. Valuing depreciating property and equipment using income tax requirements often results in differences from measurements that would be required by GAAP. Which of the following is **not** considered one of the differences? **(Page 138)**
- a. Requirements for capitalizing leases that is less flexible than GAAP. [This answer is correct. Requirements for capitalizing leases are more flexible than for GAAP. Also, the income tax rules require amortization of assets under capitalized leases over the depreciable lives used for income tax reporting, whereas SFAS No. 13, *Accounting for Leases*, requires depreciation of some capitalized leases over the lease term.]**
 - b. Using the purchase method to account for stock acquisition of a company. [This answer is incorrect. The use of the purchase method to account for the acquisition of the stock of a company may result in a different depreciable basis for income tax reporting than for GAAP is considered one of the differences.]
 - c. Assets valued at the owner's tax basis that are contributed by an owner. [This answer is incorrect. Assets contributed by an owner may be valued at the owner's tax basis rather than at the fair value required for GAAP by APB Opinion No. 29, *Accounting for Nonmonetary Transactions* is considered one of the differences.]
11. Which of the following statements regarding internal-use computer software costs is most accurate? **(Page 141)**
- a. The cost of internal-use software should be deducted. [This answer is incorrect. Under GAAP, the capitalized costs of internal-use software generally should be amortized on the straight-line basis over the estimated useful life of the software.]
 - b. Software may be purchased separately or along with hardware. [This answer is correct. The tax treatment of the cost of software that is purchased along with hardware depends on whether the cost of the software is specifically identified in the purchase documents, which Revenue Procedure**

- 2000-50 refers to as being “separately stated.” The cost of software that is purchased separately, or that is purchased along with hardware but is separately stated, should be capitalized and amortized over three years using the straight-line method. The cost of software that is purchased along with hardware but is not separately stated should be capitalized as part of the hardware, which under MACRS is five-year property.]**
- c. Software lease payments are not deductible. [This answer is incorrect. Payments for software leases, which are typically written in the form of licenses, are deductible.]
 - d. Purchased and leased software costs generally are not accounted for the same in tax basis and GAAP financial statements. [This answer is incorrect. Costs of purchased software and leased software are likely to be accounted for the same in tax basis and GAAP financial statements, with the costs of purchased software capitalized and the cost of leased software charged to expense.]
12. Louis and Sons Jewelry (J&S) incurs business start-up costs in 2009. How will the company deal with the start-up costs under the income tax basis of accounting? **(Page 142)**
- a. The company will capitalize and amortize the start-up costs over three years using the straight-line method. [This answer is incorrect. This method would be used for the cost of computer software that was purchased separately or purchased along with hardware and separately stated.]
 - b. J&S can charge the start-up costs to operations when incurred or capitalize and expense them over five years. [This answer is incorrect. This method describes how the intangible drilling costs of oil and gas properties would be dealt with for income tax reporting purposes.]
 - c. **J&S can deduct \$5,000, reduced by the amount which the start-up costs exceed \$50,000. [This answer is correct. This is the method J&S should use to deduct its business start-up costs. Once the \$5,000 has been deducted, the remainders of the costs are amortizable over 180 months beginning with the month in which J&S began an active trade or business.]**
13. Which of the following costs includes all costs incurred in selling interests in a partnership? **(Page 144)**
- a. Organizational. [This answer is incorrect. Whenever a new C corporation, S corporation, or partnership is formed, certain costs associated with its creation are incurred. Organization costs are generally expensed when incurred under GAAP.]
 - b. **Syndication. [This answer is correct. Syndication costs include all costs incurred in promoting or selling interests in a partnership. For income tax purposes, syndication costs must be capitalized as an asset. They may not be amortized, nor may they be deducted if the syndication effort is abandoned. Accounting for syndication costs for tax purposes differs from GAAP, which generally requires syndication fees to be offset against equity.]**
14. Which of the following statements regarding environmental cleanup costs is most accurate? **(Page 145)**
- a. **State and federal laws impose costly legal obligations on owners of environmentally damaged properties. [This answer is correct. Federal and state laws impose legal obligations on owners of environmentally damaged properties and those obligations can be very costly. Examples of costs incurred as a result of those obligations, which are often referred to as environmental cleanup costs or environmental remediation costs are soil removal and disposal costs, fines, engineering fees, and legal fees.]**
 - b. Environmentally cleanup costs generally are recognized sooner in income tax statements than in GAAP financial statements. [This answer is incorrect. Generally, environmental cleanup costs are likely to be recognized sooner in GAAP financial statements than in income tax basis statements. Revenue Ruling 94-38 generally requires following the economic performance rules of Section 461(h) of the Internal Revenue Code to determine when environmental cleanup costs are recognized.]

- c. Revenue Ruling 94-38 provides guidance for determining when to recognize environmental cleanup costs in GAAP financial statements. [This answer is incorrect. SOP 96-1, Environmental Remediation Liabilities, provides guidance for determining when to recognize environmental cleanup costs in GAAP financial statements. Generally, the entity should recognize a liability for environmental cleanup costs, which the SOP referred to as an environmental remediation liability, when it is probable that a liability for those costs has been incurred and when the amount of the liability can be reasonably estimated.]
 - d. Costs deducted under Section 198 are recognized as an expense in GAAP statements. [This answer is incorrect. Costs deducted under Section 198 would be recognized as an expense in tax basis statements but would be charged to an asset in GAAP statements.]
15. Which of the following would be appropriate for the financial statements of a C corporation using the accrual method for federal income tax purposes? **(Page 146)**
- a. The equity section of the balance sheet should have the label "member's equity." [This answer is incorrect. This would be true if the company were a limited liability company.]
 - b. A single retained earnings amount should be reported on the tax basis balance sheet. [This answer is incorrect. If the company were an S corporation, this would be true. In that case, instead of presenting individual amounts such as the accumulated adjustments account, one retained earnings amount should be presented.]
 - c. **Each class of stock should be disclosed on the face of the tax basis balance sheet. [This answer is correct. For each class of stock, the following information is usually disclosed: (1) title of issue, (2) par value per share, (3) shares authorized, and (4) shares issued.]**
 - d. Negative equity or capital should be reported on the tax basis balance sheet. [This answer is incorrect. The terms *equity* and *capital* should not be used when referring to negative amounts. Instead, a caption such as "deficiency in assets" could be used.]
16. Select from the following answer choices the one that matches the definition below.
- Definition:** A 10-year lease may require the tenant to pay \$2,000 per month for the first two years, \$2,500 per month for the next three years, and \$3,500 per month for the remaining five years. **(Page 152)**
- a. Deferred rent rule. [This answer is incorrect. The deferred rent rules require the landlord and the tenant to impute interest on any deferred rent payment.]
 - b. Free rent. [This answer is incorrect. Particularly in distressed real estate markets, developers may offer new tenants "rent holidays." For example, to sign a tenant to a 10-year lease, the developer may offer a lease that does not require the tenant to pay rent until the first day of the third year.]
 - c. **Stepped rent. [This answer is correct. Stepped rent describes rental payments that generally increase or decrease over the lease term. For example, a 10-year lease may require the tenant to pay \$2,000 per month for the first two years, \$2,500 per month for the next three years, and \$3,500 per month for the remaining five years. Leases like these are particularly attractive to fledgling businesses that expect revenues to increase dramatically over the first few years of operations.]**
17. Which of the following is an example of a nondeductible expense? **(Page 152)**
- a. Meals and entertainment expenses. [This answer is incorrect. A portion of meals and entertainment expenses is deductible expense, and a portion of the meals and entertainment expenses is nondeductible.]
 - b. **Penalties and fines. [This answer is correct. Nondeductible expenses (or the excess of expenses incurred above the deductible amount) should be recognized on the financial statements the year in which they were incurred. Penalties and fines are not deductible.]**

- c. Life insurance premiums. [This answer is incorrect. Life insurance premiums are deductible if the beneficiary is someone other than the entity. Premiums that are paid for life insurance on employees or officers are nondeductible expenses if the entity is the beneficiary.]
18. Coastal Construction (CC) wants to present its financial statements using the cash method of accounting for income tax purposes. Which of the following will preclude CC from making that choice? **(Page 154)**
- a. **CC maintains significant inventories. [This answer is correct. Maintaining or being required to maintain inventories means that CC cannot use the cash method.]**
- b. CC does not have any unrecorded contract receivables or payables. [This answer is incorrect. This would allow CC to use the cash method. The company could not use the cash method if it had significant unrecorded contract receivables or payables because it would significantly distort income.]
- c. CC recognizes deductions based on disbursements. [This answer is incorrect. Recognizing deductions based on disbursements and income based on payments received or constructively received is appropriate accounting under the cash method.]
- d. CC receives payments subject to restriction. [This answer is incorrect. This would not affect CC's ability to use the cash method. Payments CC receives subject to restriction (e.g., payments received in advance of performing certain functions) may be excluded from income.]
19. Select the scenario that best describes a company using the cash method of accounting for income tax purposes? **(Page 154)**
- a. Shelton-Morgan amortizes organization costs over 60 months, starting with the month invoices for the costs were received. [This answer is incorrect. The amortization begins in the month that the costs are paid.]
- b. **CalendarCo takes a bad debt deduction for cash that it transferred to LLT Company before LLT went bankrupt. [This answer is correct. If the company has an actual cash loss, a bad debt deduction can be claimed. Alternatively, the deduction could be claimed if CalendarCo previously included that amount in income.]**
- c. Swift Production, LLC, recognizes federal income tax expenses and related liabilities on its financial statements. [This answer is incorrect. Only a C corporation's cash method financial statements should present income taxes. An LLC's income is taxed to the individual owners.]
- d. Real Estate Management, Inc., recognizes rental income on its financial statements when the rent is due. [This answer is incorrect. Cash method statements should recognize rental income when it is received.]

DISCLOSURE CONSIDERATIONS

The disclosure requirements under the tax basis of accounting are not as well defined as they are under GAAP. Guidance on disclosures in income tax basis financial statements is found in the auditing literature—SAS No. 62 (AU 623.09–.10) and Interpretation 14 (AU 9623.90–.95) of the SAS. SAS No. 62 requires tax basis financial statements to disclose the basis of the presentation and how it differs from GAAP and to include informative disclosures appropriate for the basis of accounting. It adds that disclosures similar to GAAP should be made when OCBOA financial statements contain items similar to GAAP financial statements and that the need for disclosures related to matters not specifically identified on the face of the statements should be considered. Interpretation 14 clarifies the guidance in SAS No. 62 and generally requires tax basis financial statements to either follow the relevant GAAP disclosure requirements or provide information that communicates the substance of those GAAP requirements.

Basis of Accounting

SAS No. 62 requires disclosure of the basis of accounting used to prepare the financial statements and a description of how that basis differs from GAAP. The intent of the disclosure is to warn the financial statements' users that the basis of accounting is not GAAP, not to reconcile the tax basis to a GAAP presentation. Accordingly, SAS No. 62 does not require the differences between the income tax basis and GAAP to be quantified in the disclosure. In addition, Interpretation 14 notes that the disclosure can be brief and requires only the primary differences to be described.

Normally, the disclosure of the basis of accounting can be presented at the beginning of the summary of significant accounting policies using a heading such as Basis of Accounting. Some entities indicate in the disclosure whether the cash or accrual method is used for the income tax basis of accounting.

In addition, some entities note in the disclosure that the income tax basis is a comprehensive basis of accounting other than generally accepted accounting principles and that the accompanying financial statements are not intended to present financial position and results of operations in conformity with generally accepted accounting principles. While that information is not required, it can be included if entities find it to be meaningful.

Accrual Method. The following illustrates the basis of accounting disclosure when the accrual method is used:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

The accompanying financial statements have been prepared on the accounting basis used by the Company for federal income tax purposes. Primary differences between the income tax basis of accounting and generally accepted accounting principles (GAAP) include the use of the direct write-off method for bad debts instead of the reserve method under GAAP. In addition, accelerated methods and shorter lives are used for depreciating property and equipment for tax purposes. GAAP depreciates assets to estimated salvage value over the useful life of the asset.

The disclosure could be modified to indicate use of the accrual method for income tax purposes as follows (changes are indicated in *italics*):

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

The accompanying financial statements have been prepared on the *accrual basis of accounting* used by the Company for federal income tax purposes. Primary differences between the income tax basis of accounting and generally accepted accounting principles (GAAP) include the use of the direct write-off method for bad debts instead of the reserve method under GAAP. In addition, accelerated methods and shorter lives are used for depreciating property and equipment for tax purposes. GAAP depreciates assets to estimated salvage value over the useful life of the asset.

Cash Basis. The following illustrates an example basis of accounting disclosure if the cash method is used for income tax reporting:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

The Corporation prepares its financial statements on the income tax basis of accounting. Under that basis, certain revenues and the related assets are recognized when received rather than when earned, and expenses generally are recognized when paid rather than when the obligation is incurred. Consequently, accounts receivable and trade accounts payable are not reflected in the accompanying financial statements.

The disclosure could be modified to indicate the cash method is used for income tax purposes as follows (changes are indicated in italics):

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

The Corporation prepares its financial statements on the *cash method of accounting used for federal income tax purposes*. Under that basis, certain revenues and the related assets are recognized when received rather than when earned, and expenses generally are recognized when paid rather than when the obligation is incurred. Consequently, accounts receivable and trade accounts payable are not reflected in the accompanying financial statements.

Immaterial Differences from GAAP. SAS No. 62 does not preclude entities from presenting their financial statements on the income tax basis of accounting when the financial results do not differ materially from GAAP results. For example, the financial statements might be described as being on the income tax basis if the partners expect to see tax basis statements because of the requirement in a partnership agreement. The following illustrates an example basis of accounting disclosure if the financial results do not differ materially from GAAP:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

The accompanying financial statements have been prepared on the basis of accounting used for federal income tax reporting. There are no substantive differences between that basis and generally accepted accounting principles.

Numerous Differences from GAAP. For some entities, there may be several significant differences between the income tax basis and GAAP. Those differences may be disclosed in one paragraph. Alternatively, some accountants believe the presentation is less cumbersome if the significant differences are separately listed in the basis of accounting note. The following is an example disclosure with the significant differences disclosed in one paragraph:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

The Company prepares its financial statements on the income tax basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles. That basis differs from generally accepted accounting principles primarily because the Company treats up to a prescribed maximum amount of qualifying property as a deduction in the year of acquisition rather than as a capital expenditure, and calculates depreciation claiming a special first-year accelerated depreciation deduction and using the statutory accelerated cost recovery periods instead of useful lives. The specific charge-off method is used to deduct bad debt

expenses related to the notes and advances receivable when collection efforts have been exhausted and the note or advance receivable is deemed worthless. As such, notes and advances receivable are carried at the amount of principal outstanding rather than at the amount expected to be collectible. There is no allowance for doubtful accounts in the financial statements. The ending inventory balance includes certain overhead expenses that are capitalized in accordance with Section 263A of the Internal Revenue Code that would not be capitalized under generally accepted accounting principles. Accordingly, the accompanying financial statements are not intended to present financial position and results of operations in conformity with generally accepted accounting principles.

An example disclosure with the same significant differences separately listed in the basis of accounting note would be as follows:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

The Company prepares its financial statements on the income tax basis of accounting, 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 generally accepted accounting principles. The following are the significant differences from generally accepted accounting principles:

- a. The Company treats up to a prescribed maximum amount of qualifying property as a deduction in the year of acquisition rather than as a capital expenditure.
- b. Depreciation is calculated using the statutory accelerated cost recovery periods instead of useful lives.
- c. The specific charge-off method is used to deduct bad debt expenses related to the notes and advances receivable when collection efforts have been exhausted and the note or advance receivable is deemed worthless. As such, notes and advances receivable are carried at the amount of principal outstanding rather than at the amount expected to be collectible. Accordingly, there is no allowance for doubtful accounts in the financial statements.
- d. The ending inventory balance includes certain overhead expenses that are capitalized in accordance with Section 263A of the Internal Revenue Code and would not be capitalized under generally accepted accounting principles.

Other Example Disclosures of Differences between the Income Tax Basis and GAAP. The following are additional example disclosures of differences between the income tax basis and GAAP:

- Gains on sales of certain assets have been reported on the installment method and are being recognized over the periods in which the payments are received rather than recognized as income in the year of sale.
- Percentage depletion allowable for federal income tax purposes is recorded in the accounts to the extent of leasehold and royalty investment. Under GAAP, only cost depletion would be recognized as depletion expense.
- The Company expenses intangible development costs and all dry hole costs as incurred. Under GAAP, the capitalization and amortization of intangible development costs and development well dry hole costs would depend on whether the full cost or successful efforts method of accounting were used.
- Investments in partnerships are carried at tax basis equity rather than at GAAP basis equity.
- Marketable securities are carried at cost regardless of market value at the end of the year. Losses on investments are recorded upon disposition of the investment rather than providing for such losses as they occur.

- The Company charges payments under the leases described in Note X directly to operations instead of accounting for them as financing the acquisition of an asset.
- Rental income is recognized when due instead of using the straight-line method over the lease terms.
- The Company expenses defined benefit retirement plan contributions based on amounts deductible for federal income tax purposes. Under GAAP, pension expense would be computed based on Statement of Financial Accounting Standards No. 87 (FASB ASC 715-10).
- The Company expenses certain lump sum retirement benefits in the period in which the benefits are paid. Under GAAP, such benefits would be recorded in the period in which each employee becomes entitled to the benefits.
- The basis of land under development contributed by a partner is that partner's tax basis instead of the fair value at the date of contribution.
- The gross profit from the sale of lots prior to substantial completion of development is recognized immediately instead of being recognized as development progresses.
- Prepayments for services that will be used within 8½ months from the statement of assets and liabilities date are expensed in the year paid. GAAP requires the characterization of prepaid expenses as an asset when they will expire after the statement of assets and liabilities date.

Significant Accounting Policies

APB Opinion No. 22, *Disclosure of Accounting Policies* (FASB ASC 235-10-50-1), generally requires GAAP financial statements to disclose all significant accounting policies used by the reporting entity. It specifically requires disclosure of accounting principles involving any of the following:

- a. A selection from existing acceptable alternatives
- b. Industry peculiarities
- c. Unusual or innovative applications of accounting principles

Other pronouncements also require disclosure of accounting policies in GAAP basis financial statements. Best practices indicate that the guidance should also be followed in tax basis presentations.

Selections from Alternatives. Best practices indicate that just as the selection from existing acceptable alternatives would be disclosed under GAAP, selections from alternatives that exist for income tax reporting should be disclosed under the tax basis. The following are some common examples where federal income tax laws allow a selection from acceptable alternatives:

- Construction contracts
- Depletion
- Installment method
- Intangible drilling costs

Generally, sufficient disclosure of those items often is provided in the basis of accounting note discussing the significant differences between GAAP and the income tax basis of accounting. Therefore, best practices indicate that additional disclosure of those items always is required in the summary of significant accounting policies note.

Industry Peculiarities. APB Opinion No. 22 (FASB ASC 235-10-50-3) requires accounting principles and methods peculiar to the entity's industry to be disclosed, even if those principles and methods are predominantly followed

in that industry. For example, an entity in the real estate industry would disclose accounting principles and methods that are peculiar to that industry. Best practices indicate that those accounting principles and methods should also be disclosed in tax basis financial statements.

Unusual or Innovative Applications. Best practices indicate that the tax basis counterpart to the APB Opinion No. 22 (FASB ASC 235-10-50-3) requirement to disclose unusual or innovative applications is the disclosure of items for which GAAP and income tax regulations clearly prescribe a different accounting treatment. However, sufficient disclosure for those items usually is provided in the basis of accounting note when the items result in significant differences between GAAP and the income tax basis of accounting. Therefore, no additional disclosure of those items is required in the summary of significant accounting policies note. The following are common examples of items that fall within that category:

- Basis of contributed assets
- Depreciation period for assets under capital leases
- Equity method, including negative bases of investments
- Marketable equity securities
- Stepped-up basis

Example Disclosures of Significant Accounting Policies

The following paragraphs discuss example significant accounting policy notes in income tax financial statements. Some of the policies could be disclosed by expanding the discussion of the differences between GAAP and the income tax basis of accounting in the "Basis of Accounting" note.

Income Taxes. Although not required, if the entity is a pass-through organization such as an S corporation, partnership, or sole proprietorship, best practices are to indicate the filing status. That status normally is indicated through a disclosure, usually labelled "Income Taxes," in the summary of significant accounting policies.

Some accountants also indicate the treatment of any nontaxable income or nondeductible expenses in the summary of significant accounting policies. The following is an example policy disclosure that could be included:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Income Taxes

Although income tax rules are used to determine the timing of the reporting of revenues and related assets and expenses and related obligations, nontaxable revenues and nondeductible expenses are included in the determination of net income.

Basis of Consolidation. Best practices indicate that consolidated financial results should be presented in the tax basis financial statements if a consolidated income tax return is filed. APB Opinion No. 22 (FASB ASC 235-10-50-4) requires the basis of consolidation to be disclosed in GAAP financial statements. The following is an example disclosure:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The accompanying consolidated financial statements include Tyson Petroleum Company and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

Inventories. The accounting policy for pricing inventory should be disclosed either in the notes to tax basis financial statements or in the caption on the statement of assets, liabilities, and equity. The following is an example policy disclosure for inventories that could be used in tax basis financial statements:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Inventories

Inventories are stated at the lower of cost (determined by the first-in, first-out method) or market.

Receivables. If the entity has material amounts of receivables, the summary of significant accounting policies should disclose the information required by SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others* (FASB ASC 310-10-50).

Depreciation Methods. While the disclosure of depreciation methods need only address the use of prescribed periods and methods, it may be more extensive, as the following illustrates:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Depreciation

The cost of rental property is depreciated using the straight-line method over prescribed periods of 27.5 and 39 years.

Business Start-up Costs and Organization Costs. Similar to the disclosure of depreciation methods and the amortization methods of intangible assets, it is common for the accounting policy related to business start-up costs and organization costs to be disclosed in the summary of significant accounting policies. An example accounting policy note for business start-up costs is as follows:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business Start-up Costs

Prior to the commencement of business, the Company incurred certain start-up costs relating to the development of the hardware store, training employees, and a preopening marketing campaign. Those costs amounted to \$25,000 as of March 1, 20X7 (the date the Company commenced business). Under generally accepted accounting principles, those costs would be expensed as incurred. For income tax purposes, however, some of those expenses have been capitalized, and are being amortized, using the straight-line method, over 15 years.

As previously discussed, however, that accounting policy may be included in the basis of accounting note since it indicates a difference between the tax basis and GAAP.

An example accounting policy note for a company that capitalized organization costs is as follows:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization Costs

Capitalized organization costs are being amortized, using the straight-line method, over 15 years.

Revenue and Cost Recognition. Disclosure of revenue and cost recognition policies is normally useful information. In addition, the accounting policy for recognition of profit on long-term construction contracts is required in the notes to GAAP basis financial statements. An illustration of disclosure of revenue and cost recognition policies in the tax basis financial statements of a land developer follows:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Revenue and Cost Recognition

Revenues from lot development and homebuilding are recognized upon closing of the sale. If a lot is sold prior to completion of development, provision is made for the estimated remaining costs to complete development of those lots.

Lot acquisition, materials, and other direct costs and interest and other indirect costs related to acquisition, development, and construction of lots and homes are capitalized. Direct and indirect costs of developing residential lots are allocated to individual lots based on their relative sales value. Capitalized costs of residential lots and homes are charged to earnings when the related revenue is recognized. Costs incurred in connection with developed lots and completed homes and other selling and administrative costs are charged to earnings when incurred.

Related-Party Transactions

SAS No. 62 at AU 623.10 notes that disclosure of related party transactions should be considered when assessing the adequacy of disclosures in tax basis financial statements. SFAS No. 57, *Related Party Disclosures* (FASB ASC 850-10-50-1), requires GAAP basis financial statements to include the following disclosures for related party transactions:

- a. The nature of the relationship with a related party.
- b. A description of the related party transactions.
- c. The dollar amounts of the transactions.
- d. Amounts due from or to related parties as of the date of each balance sheet presented.

According to Interpretation 14 of SAS No. 62 (AU 9623.90–.95), the substance of the disclosure requirements found in SFAS No. 57 (FASB ASC 850-10-50-1) can be communicated in the financial statements in ways other than disclosing the dollar amounts of the transactions. For example, the notes might disclose that approximately 10% of the sales were to related parties or that the notes receivable were primarily from partners.

In addition, some accountants disclose related party transactions in tax basis financial statements based on the definitions of related party included in the IRC rather than the definition included in SFAS No. 57 (FASB ASC 850-10-20). Accordingly, certain transactions, such as transactions with an entity's management, may not be disclosed as a related party transaction in those tax basis financial statements. An example disclosure is as follows:

Certain individuals and entities, not considered related parties for federal income tax purposes, would be considered related parties and would require additional disclosure under GAAP.

An entity that uses the accrual basis for income tax reporting would not recognize a liability and the related expense for interest due on an obligation to a related party that uses the cash basis for income tax reporting. However, it may be necessary to disclose an obligation for interest incurred but not recognized in order to keep the financial statements from being misleading. An example follows.

NOTE X—OBLIGATION UNDER RELATED-PARTY NOTES

The carrying amount of the obligation under related-party notes is the total principal outstanding under notes payable to XYZ Enterprises (XYZ). One of the major stockholders has a controlling financial interest in XYZ. The notes are due on demand, bear interest at 1% above prime payable annually, and are unsecured. Interest for the year totaled \$65,000 and was paid in February 20X9. Interest expense under the notes is recognized when paid rather than when the obligation is incurred because XYZ uses the cash basis for income tax reporting. Accordingly, the Company's \$65,000 obligation for interest incurred but not paid at year-end has not been recognized in the accompanying financial statements.

Commitments and Contingencies

Accountants should consider the existence of commitments and contingencies for disclosure in the notes to the financial statements. Commitments are contractual obligations for a future expenditure. Contingencies are existing conditions that may create a legal obligation in the future but that arise from past transactions or events. Commitments and contingencies may require disclosure because of their effect on the tax basis balance sheet or on future revenues and expenses.

SFAS No. 5 *Accounting for Contingencies* (FASB ASC 450-10), provides the accounting guidance for recording contingencies in GAAP basis financial statements. The proper accounting treatment of contingencies depends on the likelihood (probable, reasonably possible, or remote) that a future event will confirm that a gain or loss has occurred and on the ability to make a reasonable estimate of the outcome. SFAS No. 5 (FASB ASC 450-20-25-2) requires accrual of loss contingencies if information available prior to financial statement issuance indicates that it is *probable* that an asset has been impaired or a liability incurred at the date of the financial statements and the amount of the loss is reasonably estimable. If an accrual is not made for a loss contingency because one or both of those conditions are not met, but there is a *reasonable possibility* that a loss may have been incurred, the notes to the financial statements must disclose the nature of the contingency and give an estimate of the loss or range of loss or state that such an estimate cannot be made.

Under federal income tax laws, entities generally cannot accrue an expense until any uncertainty associated with the expense is eliminated and the liability becomes fixed and certain. Accordingly, contingencies generally cannot be recorded in tax basis financial statements. Although contingencies generally cannot be recorded in income tax basis financial statements, the disclosures that would be required by SFAS No. 5 (FASB ASC 450-20-50) may be necessary to keep tax basis statements from being misleading.

Impairment of Assets

While GAAP requires recognizing impairment of certain assets (such as for the excess of the carrying amount of land to be disposed of over its fair value less selling costs), impairment losses generally are not deductible for income tax purposes until the investments become totally worthless or the interest is abandoned. Nevertheless, the authors believe disclosure of impairment provides the reader of tax basis financial statements with useful information, even though an impairment loss is not recognized, and may be necessary to keep the financial statements from being misleading. As a practical consideration, since tax-planning sessions often address anticipated losses, the information for the disclosure often is available. An example of a disclosure related to the impairment of real estate follows:

NOTE X—LAND UNDER DEVELOPMENT

Losses totalling approximately \$110,000 are expected on the sale of the remaining land under development. Those losses are deductible when realized and are not reflected in the accompanying financial statements.

Investments

Interpretation 14 of SAS No. 62 (AU 9623.90–.95) notes that the fair value information that would be required by SFAS No. 115 (FASB ASC 320-10) is not relevant to tax basis financial statements since investments are carried at cost in the tax basis statement of assets, liabilities, and equity. However, best practices indicate some of the SFAS No. 115 (FASB ASC 320-10-50) disclosures would apply, such as information about the contractual maturities of debt securities as of the date of the most recent tax basis balance sheet presented. In addition, some entities believe that disclosure of fair values of investments provides useful information to users of income tax basis financial statements concerning investment performance. Accordingly, some entities include disclosures such as aggregate fair value and different types of gains and losses as of the date of each tax basis statement of assets, liabilities, and equity in the notes to the financial statements.

The following is an example disclosure of the fair value of marketable equity securities if fair values are disclosed:

NOTE X—MARKETABLE EQUITY SECURITIES

Marketable equity securities consist of common stocks. The fair value of those securities at December 31, 20X8 and 20X7, is as follows:

	20X8	20X7
Amortized cost	\$ 66,590	\$ 66,590

Gross unrealized gains	12,550	11,175
Gross unrealized losses	<u>(5,698)</u>	<u>(5,325)</u>
Fair value	<u>\$ 73,442</u>	<u>\$ 72,440</u>

Some entities may choose to disclose the market value of their investments by expanding the caption on the face of the tax basis balance sheet, as the following illustrates:

Investment in marketable securities, at cost (quoted market \$73,442 in 20X8 and \$72,440 in 20X7)	\$ 66,590	\$ 66,590
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Property and Equipment

The balance of major classes of property and equipment should be disclosed by nature or function. Generally, the disclosure of depreciation in tax basis financial statements should be the same as that in GAAP financial statements. Accordingly, best practices indicate that total accumulated depreciation, depreciation expense for each of the periods presented, and a general description of the method or methods used in computing depreciation expense should be disclosed.

Terms of Debt and Lease Agreements

Following the guidance in Interpretation 14 of SAS No. 62 (AU 9623.90–.95), the terms of debt and lease agreements should be disclosed in tax basis financial statements. Disclosures related to significant debt agreements also should include a discussion of interest rates, maturity dates, pledged assets, and restrictive covenants.

Interpretation 14 states that either GAAP disclosure requirements should be followed for a particular item or information should be provided that communicates the substance of the GAAP requirements.

Restrictions on Assets and Equity (Capital)

SAS No. 62 (AU 623) states that disclosure of owners' equity in OCBOA financial statements should be comparable to that in GAAP financial statements. It also notes that disclosure of restrictions on assets and owners' equity should be considered when assessing the adequacy of disclosures in tax basis financial statements. Accordingly, disclosure of restrictions on any assets or on stockholders' equity, partners' capital, or proprietor's capital (e.g., the inability to pay dividends to stockholders or limitations on the sale of assets imposed by debt agreements) may be necessary to keep tax basis financial statements from being misleading.

Employee Benefit Plans

If an entity sponsors a pension plan for its employees or provides other postretirement or post-employment benefits, the financial statements should include disclosures about the plan. SFAS No. 132R (Revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits, an amendment of FASB Statements No. 87, 88, and 106*, standardizes the disclosure requirements for such plans and allows alternative, reduced disclosures for nonpublic entities. Those requirements only affects disclosures about defined benefit pensions and other postretirement benefit plans.

While SFAS No. 132R (FASB ASC 715-20-50) does not require disclosure of general descriptive information about benefit plans (such as employee groups covered, type of benefit formula, and funding policy), the authors believe that such disclosures often provide helpful and meaningful information. Accordingly, the note disclosure about the plan might include that information in addition to the type of plan sponsored (i.e., defined contribution or defined benefit) and the amount of contributions to the plan for each period that a statement of revenues and expenses is presented.

Among other things, an entity (including a not-for-profit organization) is required to recognize the funded status of a defined benefit postretirement plan in the financial statements and disclose in the notes to financial statements

additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation.

Disclosure requirements in SFAS No. 132R, as amended by, SFAS No. 158 (FASB ASC 715-20-50), or SFAS No. 112 (FASB ASC 420-10-15-6; 420-10-5-4; 712-10-15-3; 712-10-15-4; 712-10-25-4; 712-10-25-5; 712-10-35-1; 712-10-50-2; 712-10-5-5; 712-10-5-6), *Employers' Accounting for Postemployment Benefits* (FASB ASC 712-10-50), that are not relevant to tax basis financial statements do not need to be considered. For example, Interpretation 14 of SAS No. 62 notes that the actuarial information required by GAAP would not be relevant in income tax basis financial statements since those presentations do not consider the actuarial calculations when measuring contributions to defined benefit plans. There may be situations where information about significant unfunded accumulated benefits should be provided in the notes, however, to keep the financial statements from being misleading.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

20. Which of the following scenarios describes a requirement when using the income tax basis of accounting?
- a. Honest John's financial statements include a brief disclosure of the basis of accounting used to prepare the statements and a description of the primary differences between it and GAAP.
 - b. Simple Simon reconciles the tax basis to a GAAP presentation in its financial statement disclosures.
 - c. Jack and Jill's Coffee Shop's financial statements disclose that it is using the accrual method of accounting for income tax purposes.
21. Which of the following disclosures represents the inventory disclosure for income tax financial statements?
- a. Although income tax rules are used to determine the timing of the reporting of revenues and related assets and expenses and related obligation, nontaxable revenues and nondeductible expenses are included in the determination of net income.
 - b. The cost of improved property is depreciated using the straight-line method over prescribed periods of 27.5 and 39 years.
 - c. Inventories are stated at the lower of cost (determined by the average cost method) or market.
 - d. Capitalized organization costs are being amortized, using the straight-line method, over 15 years.
22. Which of the following should be disclosed in the notes to the financial statements because of its effect on the tax balance sheet?
- a. Contingencies.
 - b. Related-party relationships.
23. Which of the following scenarios best illustrates required or highly recommended disclosures for income tax basis financial statements?
- a. Jumping Jamboree discloses the balance of major classes of property and equipment by nature and function only.
 - b. Blue Moose Enterprises does not include the fair value information about investments required by SFAS No. 115 as a disclosure to the financial statements, but does include the contractual maturities of its debt securities.
 - c. PX-3 sponsors a pension plan for its employees, but does not include disclosures about the plan as part of its financial statements.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

20. Which of the following scenarios describes a requirement when using the income tax basis of accounting? **(Page 163)**
- a. **Honest John's financial statements include a brief disclosure of the basis of accounting used to prepare the statements and a description of the primary differences between it and GAAP. [This answer is correct. SAS No. 62 and Interpretation 14 require and describe this disclosure. Such differences can be disclosed in one paragraph or separately listed in the notes to the financial statements.]**
 - b. Simple Simon reconciles the tax basis to a GAAP presentation in its financial statement disclosures. [This answer is incorrect. Under SAS No. 62, the tax basis of accounting does not have to be reconciled to a GAAP presentation, nor do the differences need to be quantified.]
 - c. Jack and Jill's Coffee Shop's financial statements disclose that it is using the accrual method of accounting for income tax purposes. [This answer is incorrect. Jack and Jill's Coffee Shop's can make this disclosure, but it is not required by authoritative literature.]
21. Which of the following disclosures represents the inventory disclosure for income tax financial statements? **(Page 166)**
- a. Although income tax rules are used to determine the timing of the reporting of revenues and related assets and expenses and related obligation, nontaxable revenues and nondeductible expenses are included in the determination of net income. [This answer is incorrect. This is the proper disclosure for the accounting policy relating to income taxes.]
 - b. The cost of improved property is depreciated using the straight-line method over prescribed periods of 27.5 and 39 years. [This answer is incorrect. This is the proper disclosure for accounting policy relating to the depreciation of improved property.]
 - c. **Inventories are stated at the lower of cost (determined by the average cost method) or market. [This answer is correct. This is the proper disclosure for the accounting policy relating to inventories.]**
 - d. Capitalized organization costs are being amortized, using the straight-line method, over 15 years. [This answer is incorrect. This is the proper disclosure for the accounting policy relating to organizational costs.]
22. Which of the following should be disclosed in the notes to the financial statements because of its effect on the tax balance sheet? **(Page 168)**
- a. **Contingencies. [This answer is correct. Accountants may be required to consider contingencies and commitments for disclosure in the notes to the financial statements because of their effect on the tax basis balance sheet or on future revenues and expenses. Contingencies should also be considered because they may create a future legal obligation but that arise from past events.]**
 - b. Related-party relationships. [This answer is incorrect. According to SAS No. 62, accountants should consider disclosing related party transactions when assessing the adequacy of disclosures in tax basis financial statements.]
23. Which of the following scenarios best illustrates required or highly recommended disclosures for income tax basis financial statements? **(Page 169)**
- a. Jumping Jamboree discloses the balance of major classes of property and equipment by nature and function only. [This answer is incorrect. These disclosures should be included; however, it is also

recommended that tax basis financial statements should also include total accumulated depreciation, a general description of the method(s) used in computing depreciation expense, and depreciation expense for each of the periods presented.]

- b. Blue Moose Enterprises does not include the fair value information about investments required by SFAS No. 115 as a disclosure to the financial statements, but does include the contractual maturities of its debt securities. [This answer is correct. According to Interpretation 14 of SAS No. 62, the fair value information required by SFAS No. 115 is not relevant to income tax basis financial statements because investments are carried at cost in the tax basis statement of assets, liabilities, and equity. Although not required, some entities believe these disclosures provide useful information to users of the statements, and therefore, choose to include them anyway.]**
- c. PX-3 sponsors a pension plan for its employees, but does not include disclosures about the plan as part of its financial statements. [This answer is incorrect. Information about a pension plan, postretirement or postemployment benefits should be included as disclosures in the financial statements. SFAS No. 132R standardizes these disclosures.]

PRESENTING INCOME TAXES IN THE FINANCIAL STATEMENTS

Taxable Entities—C Corporations

General Considerations. Ordinarily, users of financial statements prepared on the income tax basis are interested primarily in the tax effect of earnings. Best practices indicate that C corporations using the income tax basis should measure and accrue income taxes based on the taxable earnings, even when the cash method is used for income tax reporting purposes. Estimates may be necessary, such as when the financial statements are prepared before the state or federal income tax returns are prepared.

Because the income tax basis measures revenues and expenses in conformity with income tax rules, there are no temporary differences in recognizing earnings. Accordingly, the deferred method of measuring income taxes for GAAP prescribed by SFAS No. 109, *Accounting for Income Taxes* (FASB ASC 740-10), does not apply to C corporations using the income tax basis of accounting for financial statement reporting purposes. Although the financial statements do not reflect any temporary differences, there could be items included in earnings that are not taxable or deductible for income tax reporting purposes.

The captions for the income tax accounts included in tax basis financial statements usually are the same as those in GAAP financial statements.

Alternative Minimum Tax. The corporate alternative minimum tax rules ensure that companies pay at least a minimum amount of income tax. Under the rules, a company's tax liability is the greater of taxes calculated using either the regular tax system or the alternative minimum tax (AMT) system. Income taxable under the AMT system is referred to as AMT income (or AMTI). It consists of taxable income adjusted as follows:

- a. Items designated as preference items are added to taxable income in determining AMTI. The items currently designated as preference items include percentage depletion, intangible drilling costs, tax-exempt interest on certain private activity bonds, and accelerated depreciation on certain property placed in service before 1987.
- b. Items designated as adjustments are either added to or subtracted from taxable income in determining AMTI. Some of the items currently designated as adjustments include methods used to account for long-term contracts other than the percentage-of-completion method, adjusted gain or loss on dispositions, alternative net tax operating loss deductions, mining exploration and development costs, amortization of certified pollution control facilities, Merchant Marine capital construction funds, circulation expenditures, alcohol fuel credits, the domestic production activities deduction, and special deductions for Blue Cross/Blue Shield organizations. In addition, the AMT system allows a depreciation method that adjusts depreciation for purposes of calculating AMTI. Taxable income also is increased or decreased by an adjustment for adjusted current earnings.

The presentation of income taxes resulting from the alternative minimum tax system would be the same as for income taxes calculated under the regular tax system. Additional disclosure related to the alternative minimum tax may be necessary in the notes, however, if it results in a significant difference between the tax provision and the amount that would result from applying statutory rates to pretax income.

Net Operating Losses. The net operating loss deduction allows corporations to offset income in one year with losses incurred in a previous or subsequent year. Generally, the net operating loss generated during the year can be used to offset income over a 22-year period (the two years preceding and 20 years following the loss year). The American Recovery and Reinvestment Act of 2009 allows qualifying small businesses to elect to carry back net operating losses generated in tax years beginning or ending in 2008 for up to five years to obtain refunds of taxes paid for those years. The election is only available for losses generated by businesses with average annual gross receipts of \$15 million or less over a three-year period ending with the tax year of the NOL. A net operating loss must be carried back to the appropriate number of preceding tax years and then carried over to the 20 succeeding tax years, unless the entity makes an election to forgo the carryback period. The net operating loss must be carried to the earliest year available before it can be carried to a succeeding tax year.

Under SFAS No. 109 (FASB ASC 740-20-45-3), the classification of the tax benefits of operating losses depends on the source of the income or loss in the current year. The tax benefits would be classified as either (a) a reduction of

the current-period income tax expense (or a tax benefit), (b) an extraordinary item, or (c) an element of discontinued operations. Best practices indicate that, for most small businesses, realization of tax benefits of both loss carrybacks and loss carryforwards generally will be attributable to income from continuing operations, since the criteria for reporting a transaction as an extraordinary item are rarely met and discontinued operations are not encountered frequently. Accordingly, the tax benefits of operating losses generally will be shown as a reduction of income tax expense (or as a tax benefit) in GAAP financial statements.

If operating losses are carried back to earlier periods under provisions of the tax law, an asset should be recognized in the statement of financial position for the amount of refundable taxes and a corresponding benefit should be reported in the statement of revenues and expenses. In such cases, the following presentation is appropriate:

	LOSS BEFORE INCOME TAX BENEFIT	(41,500)
INCOME TAX BENEFIT		<u>8,300</u>
	NET LOSS	<u>\$ (33,200)</u>

If the net operating loss is carried forward, the statement of revenues and expenses generally will reflect no income tax expense or benefit. However, the amounts of the loss carryforwards and their expiration dates should be disclosed in the notes to the financial statements. The following is an example note disclosure of net operating loss carryforwards:

NOTE X—INCOME TAXES

At December 31, 20X2, the Company had net operating loss carryforwards of approximately \$225,000, which will expire from 20Y3 through 20Y7.

Other Carryovers. In addition to net operating loss carryforwards, federal income tax laws allow for other carryovers of unused losses and deductions, including the following:

- Charitable contribution carryovers
- Capital loss carryovers
- Carryforwards of losses limited by at-risk rules
- Passive activity loss carryovers
- Statutory depletion (percentage depletion) carryovers

The nature and amounts of any other material tax carryovers should be disclosed in the notes to the financial statements.

The following is an example note disclosure of capital loss carryovers:

NOTE X—INCOME TAXES

The corporation incurred capital losses in the years ended December 31, 20W7, 20W8, and 20W9. Capital losses may only be used to offset capital gains, and capital losses that cannot be offset in the year they are incurred can be carried forward for offset against future capital gains for five years. The corporation used \$47,293 of the capital losses carried forward from the year ended December 31, 20W7, and at the end of the current year has unused capital loss carryovers as follows:

Year ended December 31, 20W7	\$ 51,324
Year ended December 31, 20W8	24,713
Year ended December 31, 20W9	<u>9,606</u>
	<u>\$ 85,643</u>

The following is an example disclosure of unused percentage depletion carryovers:

NOTE X—INCOME TAXES

The Company was unable to deduct percentage depletion in 20X8 and 20X7 due to certain income limitations. The amount of percentage depletion not used at December 31, 20X8, amounting to approximately \$54,000, can be carried forward indefinitely to future years.

Disclosing the Nature of Significant Differences between Expected and Actual Tax Expense. Best practices indicate that the significant reasons for the difference between the tax provision and the amount that would result from applying statutory rates to pretax income should be disclosed in the notes to the financial statements. That information can be disclosed in a reconciliation between pretax income and taxable income or in a narrative disclosure. In addition, some entities include a reconciliation to taxable income on the statement of revenues and expenses.

NOTE X—INCOME TAXES

A reconciliation of pretax book income and federal taxable income follows:

	20X8	20X7
Book income before taxes	\$ 16,150	\$ 2,934
Limitation of meals and entertainment	195	371
Life insurance	2,722	2,117
State income taxes	(631)	(179)
Federal taxable income	<u>\$ 18,436</u>	<u>\$ 5,243</u>

Similarly, the following illustrates how a reconciliation between pretax income and taxable income could appear if both federal and state income taxes were included in the income tax amount reported on the statement of revenues and expenses:

NOTE X—FEDERAL AND STATE INCOME TAXES

A reconciliation of income before income taxes with federal and state taxable income follows:

	Federal	State
Income before income taxes	\$ 741,472	\$ 741,472
State income tax	(59,090)	N/A
Nondeductible expenses	46,388	46,388
Taxable income	<u>\$ 728,770</u>	<u>\$ 787,860</u>
Income tax	<u>\$ 247,782</u>	<u>\$ 59,090</u>

Alternatively, the significant differences between “expected” tax expense and actual tax expense could be disclosed using a narrative rather than a reconciliation:

NOTE X—INCOME TAXES

The income tax provision differs from the expense that would result from applying statutory tax rates to income before income taxes because of nondeductible expenses, relating primarily to premiums paid on officers' life insurance policies. Expenses totaling \$40,000 are nondeductible and, therefore, have no tax effect.

State Income Taxes. State income taxes are deductible when they are paid or accrued, depending on the method of accounting used by the C corporation in computing taxable income. That is, a cash basis entity deducts the state income taxes in the year they are paid, without considering when the taxes are due. An accrual basis entity generally may deduct the state income taxes in the year they accrue.

The federal tax return filed by C corporations includes state income taxes as a deduction in the line for “taxes and licenses.” Accordingly, best practices indicate that state income tax expense can be reported with other expenses in the statement of revenues and expenses. Some entities may choose to include federal and state income taxes in the same caption on the statement of revenues and expenses, but, although not required, disclose them separately in the notes to the financial statements. The following is an example of that presentation on a statement of revenues and expenses:

	20X8	20X7
INCOME BEFORE INCOME TAXES	2,320,445	1,415,684
PROVISIONS FOR INCOME TAXES	<u>927,296</u>	<u>551,359</u>
NET INCOME	<u>\$ 1,393,149</u>	<u>\$ 864,325</u>

Disclosure of the federal and state provisions would then be provided in a note, as the following illustrates:

NOTE X—INCOME TAXES

For the year ended December 31, 20X8, the corporation had federal income tax of \$690,472 and Wisconsin income tax of \$236,824. For the year ended December 31, 20X7, the corporation had federal income tax of \$435,928 and Wisconsin income tax of \$115,431.

Alternatively, entities may choose to separately disclose the individual amounts of federal and state income taxes on the statement of revenues and expenses, as follows:

	20X8	20X7
NET INCOME BEFORE PROVISION FOR INCOME TAXES	99,786	137,265
PROVISION FOR INCOME TAXES:		
Federal	22,978	31,933
State	<u>12,443</u>	<u>16,787</u>
	<u>35,421</u>	<u>48,720</u>
NET INCOME	<u>\$ 64,365</u>	<u>\$ 88,545</u>

Adjustments Resulting from IRS Agent Examinations. Adjustments to income taxes paid in prior years that arise from IRS agent examinations usually fall into two categories:

- a. Those resulting from negotiated settlements of gray areas of tax law
- b. Those resulting from obvious errors such as using a capital gain rate when an ordinary income rate was appropriate

The following two alternatives may be used to account for the adjustment to prior year income taxes:

- a. Treat the adjustment as a prior-period adjustment and charge it to retained earnings.
- b. Record the additional assessment as a current year expense.

While there are sound theoretical arguments for treating adjustments resulting from IRS agent examinations as prior-period adjustments, to do so often necessitates a time-consuming and subjective evaluation of the nature of each adjustment. Practice generally has adopted that approach in GAAP financial statements. If adjustments of previously reported income tax expense are recorded as prior-period adjustments, retained earnings should be charged for the amount of the additional tax due. Penalties and interest should be reported as expenses of the year in which the additional assessment is made.

If the IRS adjustment is separately identified in the statement of retained earnings, the authors believe the notes to the financial statements should explain the nature of the adjustment. For example—

NOTE X—INTERNAL REVENUE SERVICE ADJUSTMENTS

During 20X2, the IRS completed examinations of the tax years ended December 31, 20X0 and 20W9. The examinations resulted in adjustments related primarily to security transactions with federal income taxes being incurred of approximately \$189,000, with which the Company agreed. Such taxes are included as a reduction in retained earnings in the accompanying financial statements. Interest expense of approximately \$15,000 was also paid related to the adjustments and is included as interest expense in the accompanying statement of revenues and expenses for 20X2.

Treatment of Amended Returns. The following are two common reasons for an entity filing an amended tax return:

- a. The entity is carrying back a net operating loss to a previous year.
- b. The entity incorrectly filed a tax return (i.e., certain taxable income or deductible expenses were not properly included in the tax return).

The discussion earlier in this lesson provides guidance on the presentation and disclosure of net operating losses in tax basis financial statements. The second situation involves the correction of an error. For example, assume that the financial statements of an entity were prepared based on the amounts expected to be included in the tax return. However, after the issuance of the financial statements and the original filing of the tax return, the entity realized that, due to a bookkeeping error, sales in the tax return were overstated by \$50,000. Accordingly, the entity submitted an amended return. If the amount is material, the balance of retained earnings at the beginning of the period should be restated for the effects of that error.

Differences between Financial Statements and Subsequently Issued Tax Return. In many situations, the financial statements are prepared and issued before the tax return has been completed. Accordingly, there may be differences between what is reflected on the financial statements and what is eventually reflected in the income tax return. For example, the financial statements of an entity that has interests in several real estate partnerships might be issued before all of the Schedule K-1s have been received, so the entity might have estimated the income or loss that would be attributable to certain partnerships. If the final Schedule K-1s differ from the amount reflected in the financial statements, best practices indicate that the differences should be treated as a change in estimate, and the additional amount should be reflected in the next year's financial statements. However, disclosure of the change in estimate in the subsequent year's financial statements may be necessary to keep them from being misleading.

Tax Credits

Generally, the significant reasons for a material difference between the tax provision reported in tax basis financial statements and the expected provision based on pretax income reported in the statements should be disclosed. In tax basis statements, the tax benefit of tax credits is recognized as a reduction of the tax provision in the year that the credits are elected in the tax return. Accordingly, recognition of tax credits causes a difference between the expected and actual tax provisions that should be disclosed in the notes to tax basis statements.

General business tax credits that must be offset against expenses in computing federal taxable income create an additional difference between the expected and actual provisions that requires disclosure considerations. For example, if an entity elects a \$10,000 work opportunity tax credit, compensation expense recognized in that year must be reduced by \$10,000 in determining the compensation deduction to report in the federal income tax return. Therefore, use of the tax credit converts \$10,000 of compensation expense into a nondeductible expense.

Since compensation expense reported in the tax basis statements is \$10,000 higher than the deduction in the federal return, the expected and actual tax provisions differ. However, rather than disclosing both the difference in compensation and the tax credit used as reasons for the difference between the expected and actual tax provisions, the authors believe a preferable approach is to only disclose the net tax benefit from electing the credit.

Since using the credit generated a \$10,000 nondeductible expense, the actual tax benefit of using the credit is less than \$10,000. For example, if the entity is subject to a 30% tax rate, generating a \$10,000 nondeductible expense results in a lost tax benefit of \$3,000, which is 30% of \$10,000. Accordingly, the actual benefit of using the credit is \$7,000, which is the \$10,000 credit less the \$3,000 lost benefit. Best practices indicate that disclosing the net tax benefit, rather than the two components—the tax credit and the permanent difference—better presents the substance of the benefit of electing the tax credit. For example, a note to the tax basis statements might say, “Tax credits reduced income taxes by \$7,000.” As a practical matter, however, the permanent difference often is not material, and accordingly the notes would only need to disclose the amount of the credits used.

Nontaxable Entities—S Corporations, Partnerships, and Sole Proprietorships

Disclosure of Tax-exempt Status. In nontaxable entities (such as S corporations, partnerships, and sole proprietorships), losses, tax credits, and certain other items pass from the entities to the owners. Therefore, the financial statements should not include federal income tax expense or a related liability. Carryforwards exist only at the owner level; the reporting entity has none. Although not required, because the financial statements do not reflect income taxes, the authors recommend disclosing the entities' tax-exempt status in the notes to the financial statements. However, the authors believe it is unnecessary to cite IRC sections, such as that an S election was made under IRC Section 1362.

The following examples illustrate how various entities could disclose their tax-exempt status:

S Corporation

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Income Taxes

The Company has elected to be taxed under the provisions of Subchapter S of the Internal Revenue Code. Accordingly, the financial statements do not include a provision for income taxes because the earnings and losses are included in the shareholders' personal income tax returns and are taxed based on their personal tax strategies.

Partnership

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Income Taxes

In accordance with federal income tax regulations, no income taxes are levied on a partnership, but rather on the individual partners. Consequently, no provision or liability for federal income taxes has been reflected in the accompanying financial statements.

Limited Liability Company

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Income Taxes

The Company is treated as a partnership for federal income tax purposes and does not incur income taxes. Instead, its earnings and losses are included in the personal returns of the members and taxed depending on their personal tax situations. The financial statements do not reflect a provision for income taxes.

Sole Proprietorship

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Income Taxes

The proprietorship itself is not a taxpaying entity for purposes of federal and state income taxes. Federal and state income taxes of the proprietor are computed on the individual's total income from all sources; accordingly, no provision for income taxes is made in these statements.

Taxes on Net Income. If a state or other taxing authority levies a tax on the entity and the tax is based on net income, the financial statements should show the tax as an income tax expense of the entity. For example, in some states, S corporations have an amount of income tax charged to the S corporation.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

24. What is the result when the income tax basis measures revenues and expenses in conformity with income tax rules?
- a. There are no temporary differences in recognizing earnings.
 - b. The deferred method of measuring income taxes for GAAP applies to C corporations using the income tax basis of accounting.
 - c. Financial statements should reflect any temporary differences.
25. The captions for the income tax accounts included in tax basis financial statements usually are the same as which of the following?
- a. GAAP financial statements.
 - b. Income taxes calculated under the regular tax system.
26. The amounts of the loss carryforwards and their expiration dates should be disclosed in which of the following?
- a. The notes to the financial statements.
 - b. A reconciliation between pretax income and taxable income or in a narrative disclosure.
27. According to SFAS No. 109, the classification of the tax benefits of operating losses depends on the source of the income or loss in the current year. All of the following except which one are acceptable methods of classifying a tax benefit?
- a. A reduction of the current-period income tax expense or tax benefit.
 - b. An extraordinary item.
 - c. Only as an operating loss carryback to prior periods under provisions of the tax law.
 - d. An element of discontinued operations.
28. Under the alternative minimum tax (AMT) system, preference items are added to taxable income to determine a corporation's AMT income (AMTI). Which of the following is an example of a preference item?
- a. Alcohol fuel credits.
 - b. Mining exploration and development costs.
 - c. Adjusted gain or loss on dispositions.
 - d. Tax-exempt interest on certain private activity bonds.
29. Which of the following scenarios best illustrates an appropriate treatment book and tax entries for a C corporation?
- a. Landry's Limited final Schedule K-1 differs from the amount reflected in the corporation's financial statements. The financial statements must be completely restated.

- b. Ready Made, Inc., did not properly include a material deductible expense in a previously filed income tax return and is submitting an amended tax return. However, Ready Made is not restating the beginning balance of retained earnings.
 - c. Sanford Enterprises uses the accrual method and deducts state income taxes in the year they are paid.
 - d. Amanda Arms discloses significant differences between expected and actual tax expense in a reconciliation between pretax income and taxable income.
30. Bluebonnet Fields elects to use a \$20,000 tax credit. Using the credit generates a corresponding nondeductible expense. Bluebonnet Fields is subject to a 10% tax rate. Calculate the actual benefit of using the tax credit.
- a. \$2,000.
 - b. \$18,000.
 - c. \$20,000.
 - d. \$22,000.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

24. What is the result when the income tax basis measures revenues and expenses in conformity with income tax rules? **(Page 176)**
- a. **There are no temporary differences in recognizing earnings. [This answer is correct. Because the income tax basis measures revenues and expenses in conformity with income tax rules, there are no temporary differences in recognizing earnings.]**
 - b. The deferred method of measuring income taxes for GAAP applies to C corporations using the income tax basis of accounting. [This answer is incorrect. the deferred method of measuring income taxes for GAAP prescribed by SFAS No. 109, *Accounting for Income Taxes*, does not apply to C corporations using the income tax basis of accounting for financial statement reporting purposes.]
 - c. Financial statements should reflect any temporary differences. [This answer is incorrect. Although the financial statements do not reflect any temporary differences, there could be items included in earnings that are not taxable or deductible for income tax reporting purposes.]
25. The captions for the income tax accounts included in tax basis financial statements usually are the same as which of the following? **(Page 176)**
- a. **GAAP financial statements. [This answer is correct. The captions for the income tax accounts included in tax basis financial statements usually are the same as those in GAAP financial statements.]**
 - b. Income taxes calculated under the regular tax system. [This answer is incorrect. The presentation of income taxes resulting from the alternative minimum tax system would be the same as for income taxes calculated under the regular tax system.]
26. The amounts of the loss carryforwards and their expiration dates should be disclosed in which of the following? **(Page 177)**
- a. **The notes to the financial statements. [This answer is correct. If the net operating loss is carried forward, the statement of revenues and expenses generally will reflect no income tax expense or benefit. However, the amounts of the loss carryforwards and their expiration dates should be disclosed in the notes to the financial statements.]**
 - b. A reconciliation between pretax income and taxable income or in a narrative disclosure. [This answer is incorrect. Generally, the significant reasons for the difference between the tax provision and the amount that would result from applying statutory rates to pretax income should be disclosed in the notes to the financial statements. That information can be disclosed in a reconciliation between pretax income and taxable income or in a narrative disclosure.]
27. According to SFAS No. 109, the classification of the tax benefits of operating losses depends on the source of the income or loss in the current year. All of the following **except** which one are acceptable methods of classifying a tax benefit? **(Page 176)**
- a. A reduction of the current-period income tax expense or tax benefit. [This answer is incorrect. Reducing current-period income tax expense or tax benefit is one example of the classification of tax benefits.]
 - b. An extraordinary item. [This answer is incorrect. Income tax benefits may be classified as extraordinary items.]
 - c. **Only as an operating loss carryback to prior periods under provisions of the tax law. [This answer is correct. This answer choice is a method for accounting for income tax benefits rather than the classification of an income tax benefit of an operating loss.]**
 - d. An element of discontinued operations. [This answer is incorrect. It is proper to classify a tax benefit as an element of discontinued operations.]

28. Under the alternative minimum tax (AMT) system, preference items are added to taxable income to determine a corporation's AMT income (AMTI). Which of the following is an example of a preference item? **(Page 176)**
- a. Alcohol fuel credits. [This answer is incorrect. When calculating AMTI, this is considered an adjustment instead of a preference item. Another example of an adjustment is amortization of certified pollution control facilities.]
 - b. Mining exploration and development costs. [This answer is incorrect. This is an AMTI adjustment, not a preference item. Another adjustment is methods used to account for long-term contracts other than the percentage-of-completion method.]
 - c. Adjusted gain or loss on dispositions. [This answer is incorrect. This is one of the items designated as an adjustment to AMTI. Adjustments are added to or subtracted from taxable income when determining AMTI.]
 - d. **Tax-exempt interest on certain private activity bonds. [This answer is correct. Other preference items include intangible drilling costs, percentage depletion, and accelerated depreciation on certain property placed in service prior to 1987.]**
29. Which of the following scenarios best illustrates an appropriate treatment book and tax entries for a C corporation? **(Page 178)**
- a. Landry's Limited final Schedule K-1 differs from the amount reflected in the corporation's financial statements. The financial statements must be completely restated. [This answer is incorrect. It is believed that the differences should be treated as a change in estimate; thus, the additional amount should be reflected in the next year's financial statements along with a disclosure of the change in estimate.]
 - b. Ready Made, Inc., did not properly include a material deductible expense in a previously filed income tax return and is submitting an amended tax return. However, Ready Made is not restating the beginning balance of retained earnings. [This answer is incorrect. Although the error correction would require an amended tax return, the beginning balance of retained earnings would need to be adjusted, because the error is material.]
 - c. Sanford Enterprises uses the accrual method and deducts state income taxes in the year they are paid. [This answer is incorrect. This would be correct if Sanford Enterprises used the cash basis. Users of the accrual basis should generally deduct the state income taxes in the year that they accrue.]
 - d. **Amanda Arms discloses significant differences between expected and actual tax expense in a reconciliation between pretax income and taxable income. [This answer is correct. The disclosure could also be made as a narrative disclosure. A reconciliation to taxable income on the statement of revenues and expenses could also be included.]**
30. Bluebonnet Fields elects to use a \$20,000 tax credit. Using the credit generates a corresponding nondeductible expense. Bluebonnet Fields is subject to a 10% tax rate. Calculate the actual benefit of using the tax credit. **(Page 181)**
- a. \$2,000. [This answer is incorrect. This is 10% of the tax credit, but it is not the tax credit's actual benefit.]
 - b. **\$18,000. [This answer is correct. This amount is the net tax benefit, and it is recommended that this amount be disclosed rather than the two components to better present the substance of the benefit the corporation received from electing the credit.]**
 - c. \$20,000. [This answer is incorrect. The actual benefit of using the credit is not the actual amount of the credit. It has to be adjusted by the amount of the affect the credit has on the available tax deduction.]
 - d. \$22,000. [This answer is incorrect. To calculate the actual benefit of the tax credit, you do not increase it by 10%.]

EXAMINATION FOR CPE CREDIT**Lesson 1 (OFSTG092)**

Determine the best answer for each question below. Then mark your answer choice on the **Examination for CPE Credit Answer Sheet** located in the back of this workbook or by logging onto the Online Grading System.

1. What overall accounting method(s) is (are) stipulated by the Internal Revenue Code (IRC)?
 - a. The accrual basis.
 - b. The cash basis.
 - c. The cash basis and the accrual basis.
 - d. A hybrid of the cash basis and the accrual basis.
2. A company has \$15 million in gross receipts for 2009. Apply guidance from the *Wilkinson-Beane, Inc.*, Tax Court decision to calculate the approximate dollar amount of merchandise the company could have without the merchandise being considered a significant income-producing factor.
 - a. \$1.5 million.
 - b. \$2.25 million.
 - c. \$3 million.
 - d. \$3.75 million.
3. Match the following entities with the basis of accounting that is generally correct.

1. C Corporation	i. Cash Method
2. S Corporation	ii. Accrual Method
3. Sole Proprietorship	iii. Either Cash or Accrual Method
4. Partnership	iv. The cash method, the accrual method, or both (the accrual method for business and the cash method for nonbusiness income and deductions)
5. Tax Shelter	

- a. 1., ii; 2., iii.; 3., iv.; 4., iii.; 5., ii.
- b. 1., i; 2., ii.; 3., iii.; 4., iii.; 5., iii.
- c. 1., i; 2., ii.; 3., iii.; 4., iii.; 5., iii.
- d. 1., ii; 2., iv.; 3., i.; 4., iii.; 5., ii.

4. A taxpayer uses the accrual method of accounting for income tax reporting purposes and determines that the results are not significantly different than if generally accepted accounting procedures (GAAP) had been used. Which of the following best illustrates how the taxpayer should proceed?
- Under SAS No. 62 and SSARS No. 1, entities are not prohibited from presenting tax basis statements if they do not differ materially from GAAP.
 - Only the cash method of accounting for income tax reporting purposes can be used if the financial statements do not differ materially from GAAP.
 - If the taxpayer is a nonprofit organization or a governmental entity, the income tax basis must be used.
 - Do not select this answer choice.
5. JJ Company uses the accrual method of accounting for income tax reporting purposes. When should its nontaxable revenues be recognized?
- When incurred.
 - When earned.
 - When paid.
 - When received.
6. The Weatherford-Stone Corporation is electing S status. How will that change affect the corporation's fiscal year?
- The effect of any change in fiscal year will not need to be disclosed on Weatherford-Stone's financial statements in the year of change.
 - If the corporation changes its fiscal year when electing S status, its accrual basis financial statements must reflect a full year of operations despite the short tax year.
 - The corporation must use a December 31 year end unless it pays a deposit or shows the fiscal year is its natural business year.
 - Weatherford-Stone must change both its tax year and its fiscal year for financial reporting purposes from a December 31 year end to a June 30 year end.
7. Apply the guidance found in Interpretation 14 of SAS No. 62 to determine when a statement of cash flows is required in income tax basis financial statements.
- A statement of cash flows is neither required nor prohibited by authoritative guidance.
 - When receivables and payables or contra accounts are offset.
 - When the financial statements are prepared on the cash basis used for income tax reporting.
 - When changes in stockholders' equity or changes in retained earnings are disclosed.
8. The Stylinator Boutique must record its inventory for tax purposes. Which of the following correctly illustrates one of the considerations that may affect the boutique's records?
- Cost of inventory on hand can be expensed when it is necessary to determine taxable income.
 - Certain indirect costs must be allocated to and included in the costs of inventory.
 - Items must be identified using the first-in, first-out (FIFO) or the last-in, first-out (LIFO) method.
 - Inventory for tax purposes must be valued at the lower of cost or market.

9. ShellCo holds investments. Under the income tax basis of accounting, those investments are carried at cost, regardless of their market value at the end of the fiscal year. What type of investments does ShellCo have?
- a. Investments in property and equipment.
 - b. Investments in pass-through entities.
 - c. Investments in debt and marketable equity securities.
 - d. Do not select this answer choice.
10. Which of the following scenarios best illustrates an appropriate method for dealing with intangible assets?
- a. Queenie's Quilts acquires its franchise under a serial payment arrangement and amortizes the cost over a 15-year period.
 - b. Pewter Industries acquired its IRC Section 197 intangibles on January 1, 2009, and amortizes them over a 15-year period beginning in that month.
 - c. Thomson, Nottingham, & Olson amortize the cost of its goodwill and test the goodwill for impairment once every three years.
 - d. Frazier & Lowes utilizes the 15-year safe harbor amortization period for created intangible costs with a finite useful life of ten years.
11. Sanford Arms provides accrued vacation pay and an annual bonus to its employees and shareholders. Which of the following scenarios best describes how these employee benefits should be dealt with under the accrual basis for tax reporting purposes?
- a. Sanford Arms is allowed a deduction for the cost of the benefits accrued to shareholders. when the employees include the benefit amounts in their income.
 - b. As long as federal income tax law limits are not exceeded, the company can deduct the benefits paid on or before the due date of the current year's tax return (including extensions).
 - c. The cost of the benefits must be accrued by Sanford Arms, regardless of the date that the benefits will actually be paid.
 - d. Those that are paid during the tax year or vested by the end of the tax year and paid within 2½ months of the end of the tax year can be deducted by the company.
12. The equity section of the tax basis balance sheet of a sole proprietorship generally should be labeled as which of the following?
- a. Members' Equity.
 - b. Proprietor's Capital.
 - c. Partners' Capital.
 - d. Do not select this answer choice.

13. Which of the following is defined as the taxpayer's domestic production gross receipts for the year reduced by the sum of the cost of goods sold allocable to the receipts, other deductions, expenses or losses directly allocable to the receipts, and a ratable portion of other deduction and expenses not directly allocable to the receipts or another class of income?
- a. Domestic production gross receipts.
 - b. Qualified production activities.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.
14. Which of the following best illustrates a consideration about measuring and presenting revenues and expenses on financial statements prepared using the accrual method of accounting for federal income tax purposes?
- a. Accrual basis lessees recognize rent expense under operating leases when payments are made.
 - b. Recognition of costs of goods sold generally does not differ between GAAP and the accrual method.
 - c. Advanced payments should always be recognized when the services are provided.
 - d. Entities must report earnings from long-term contracts using the completed-contract method.
15. Which of the following statements regarding guaranteed payments to partners is most accurate?
- a. Generally, partners can be both an employee and a member of the same partnership.
 - b. A partner can pay a salary to a partner who has the same tax consequences as compensation paid to a nonpartner employee.
 - c. Generally, guaranteed payments to a partner are deductible by the partnership.
 - d. Guaranteed payments are required to be disclosed in tax basis statements.
16. What type of entity must present income taxes in their tax basis financial statements?
- a. Limited liability company.
 - b. S corporation.
 - c. Partnership.
 - d. C corporation.
17. S2 Company presents its financial statements using the cash method of accounting for income tax reporting. S2 has an extensive inventory. Which of the following best describes how S2 might be affected?
- a. The accrual method must be used to account for purchases and sales of inventory.
 - b. Recognition of expenses will be deferred and recognition of income will be accelerated.
 - c. Prepaid expenses can be deducted for the current tax year and the following year.
 - d. Do not select this answer choice.

18. Which of the following describes disclosure requirements that are appropriate for income tax basis financial statements?
- a. The differences between the income tax basis and GAAP must be quantified when the basis of accounting is disclosed.
 - b. The basis of accounting is the only disclosure that must be made in income tax basis financial statements.
 - c. Income tax basis disclosure requirements are as well defined as the requirements for financial statements prepared under GAAP.
 - d. The basis of accounting, differences from GAAP, and other appropriate disclosures should be included.
19. Which of the following is **not** an example of differences between the income tax basis and GAAP?
- a. Investments in partnerships are carried at GAAP basis equity.
 - b. Instead of using the straight-line method over the lease terms, rental income is recognized when due.
 - c. The gross profit from the sale of lots prior to substantial completion of development is immediately recognized.
 - d. Gains on sales of certain assets are being recognized over the periods in which the payments are received and have been reported on the installment method rather than recognized as income in the year of sale.
20. Which of the following is **not** a common example of where federal income tax laws allow a selection from acceptable alternatives?
- a. Equity method.
 - b. Installment method.
 - c. Intangible drilling costs.
 - d. Depletion.
21. A company using the income tax basis should disclose significant accounting policies when a selection must be made between acceptable alternatives. Which of the following is an example of an area in which acceptable alternatives are available under tax law?
- a. Construction contracts.
 - b. Marketable equity securities.
 - c. Basis of contributed assets.
 - d. Depreciation period for assets under capital leases.
22. KnightCorp presents its financial statement using the income tax basis of accounting and does **not** disclose a transaction with the corporation's management. What is the ultimate authority being applied in this situation?
- a. Interpretation 14 of SAS No. 62.
 - b. SFAS No. 57, *Related Party Disclosures*.
 - c. Internal Revenue Code's definition of related party.
 - d. Do not select this answer choice.

23. Which of the following scenarios correctly illustrates how a company should account for contingencies in its income tax basis financial statements?
- a. Contingencies should never be accrued or reported on the financial statements until the liability becomes fixed and certain.
 - b. If it is likely a future event will confirm the gain/loss and a reasonable estimate can be obtained, contingencies should be accrued.
 - c. The contingencies should be accrued as expenses and recorded in the financial statements.
 - d. Do not select this answer choice.
24. Quaker Enterprises is a C corporation that uses the income tax basis of accounting. Which of these considerations will affect the corporation's financial statements?
- a. The corporation must not use the same captions that are used in GAAP financial statements for income tax accounts.
 - b. The corporation must use the deferred method of measuring income taxes to reconcile temporary differences in revenues and expenses.
 - c. Quaker Enterprises should not include estimates in its income tax basis financial statements.
 - d. Even if the cash method is used for income tax reporting purposes, Quaker Enterprises should measure and accrue income taxes based on taxable earnings.
25. What term is used when corporations offset income in one year with losses incurred in a previous year?
- a. Cost depletion.
 - b. Net operating loss carryforward.
 - c. Capital loss carryback.
 - d. Do not select this answer choice.
26. Generally, the net operating loss generated during the year can be used to offset income over a _____-year period.
- a. 20.
 - b. 21.
 - c. 22.
 - d. 25.
27. Which of the following best describes adjustments resulting from IRS agent examinations?
- a. Adjustments to income taxes paid in prior years that arise from IRS agent examinations usually consist of those resulting from negotiated settlements of gray areas of tax law.
 - b. Recording the additional assessment as a prior-year expense is one alternative that may be used to account for the adjustment to prior-year income.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.

28. In tax basis statements, the tax benefit of tax credits is recognized as which of the following?
- a. Either cash receipts or disbursements.
 - b. Revenues under generally accepted accounting principles.
 - c. Reduction of the tax provision in the year that the credits are elected in the tax return.
 - d. Do not select this answer choice.
29. Dublin Ventures elects a \$10,000 work opportunity tax credit. How does that affect compensation?
- a. Electing this tax credit will have no effect on Dublin Ventures' compensation.
 - b. If the tax credit is elected, Dublin Ventures is not allowed a compensation deduction.
 - c. A \$10,000 compensation expense will be reported in the tax return.
 - d. \$10,000 of compensation expense converts to nondeductible expense.
30. If a state or other taxing authority levies a tax on the entity and the tax is based on net income, the financial statements should show the tax as which of the following?
- a. Extraordinary item.
 - b. Adjustment of income tax expense.
 - c. Income tax expense of the entity.
 - d. Do not select this answer choice.

Lesson 2: Other Bases of Accounting

INTRODUCTION

This course provides an introduction to preparing and reporting on financial statements prepared using the income tax basis of accounting. The course discusses general and specific considerations that should be taken into account while using the income tax basis of accounting, and applies those considerations to disclosures and reporting requirements.

Learning Objectives:

Completion of this lesson will enable you to:

- Discuss the aspects of regulatory accounting and the applicable requirements.
- Identify the requirements for industries affected by regulatory accounting and the disclosures that should be made in the financial statements.
- Summarize other bases of accounting, including price-level, fair value, liquidation and agreed-upon.

TYPES OF OTHER BASES OF ACCOUNTING

Regulatory Basis

SAS No. 62, *Special Reports* (AU 623.04), and SSARS No. 1, (AR 100.04), both state that “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” is an OCBOA. SAS No. 62 (AU 623.05) allows auditors to report on financial statements prepared in conformity with the requirements of a governmental regulatory agency as an OCBOA only if the financial statements and auditor’s report are intended solely for filing with the regulatory agencies to whose jurisdiction the entity is subject. Such a basis of accounting commonly is referred to as the regulatory basis. Examples of the regulatory basis include the statutory accounting practices used by insurance companies pursuant to the rules of state insurance commissions, the regulatory accounting practices used by certain small credit unions (i.e., less than \$10 million in assets), and the basis used by contractors in submitting state prequalification reports as a condition for bidding or working on government projects.

Price-level Basis

Both SAS No. 62 and SSARS No. 1 consider an OCBOA to be a definite set of criteria having substantial support used to prepare financial statements prepared on that basis. Both SAS No. 62 and SSARS No. 1 include the cash, tax, and regulatory basis as examples of OCBOAs. SAS No. 62 (but not SSARS No. 1) goes on to also give the price-level basis of accounting as an example of an OCBOA.

Other Bases

Because the price-level basis of accounting is the only example of an OCBOA beyond the cash, tax, and regulatory bases mentioned in SAS No. 62, many accountants have questioned whether the following accounting bases should be considered OCBOAs:

- *Fair Value Basis.* Using the definition in SFAS No. 157, *Fair Value Measurements* (FASB ASC 820-10-20), *fair value* is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
- *Liquidation Basis.* The liquidation basis of accounting presents assets at amounts expected to be realized in liquidation and liabilities at amounts expected to be paid to creditors.
- *Historical Cost Basis Personal Financial Statements.* Personal financial statements presented in accordance with GAAP measure assets and liabilities at their estimated current values and amounts, rather than at their historical costs.

- *Agreed-upon Basis.* An agreed-upon accounting basis measures assets and liabilities as prescribed in an agreement or contract.

Considerations for determining whether each of the preceding accounting bases meets SAS No. 62's criteria for treatment as an OCBOA are discussed later in the lesson.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

31. Which of the following is an accounting basis that is considered an OCBOA per SAS No. 62?
- a. Liquidation Basis.
 - b. Tax Basis.
 - c. Agreed-upon Basis.
 - d. Fair Value Basis.
32. Which of the following scenarios follows the appropriate steps based on the use of the report?
- a. John is hired to audit the financial statements of commercial contractor, HB and Sons, whose only customer is the State of Texas. HB and Sons produces their financial statements as regulatory-basis statements using the cash basis of accounting and plans to use the financial statements to apply for a loan with Bank of Houston. John reviews the financial statements and issues them without modifying the auditor's report.
 - b. Steve is engaged to audit Little Elm Fire department. The department is applying to the state for additional governmental funds to do more extensive training with their employees. The financial statements are produced on the regulatory-basis as OCBOA financial statements, but did not have any material departures from GAAP. Steve expresses an adverse opinion on the audit because the statements were not GAAP, but OCBOA.
 - c. Sally audits a balance sheet for Hanson Insurance Company to be submitted to the state regulatory agency. The financial statements were prepared on a regulatory-basis. Sally included in the auditor's report a separate paragraph that the report is intended solely for the state regulatory agency and should not be used by anyone other than the specified party.
 - d. Lisa is employed by Little Angels, a nonprofit agency, to do an audit of their OCBOA financial statements that are produced on a regulatory-basis. The nonprofit is going to use the financial statements to apply with the federal government for a grant and to show contributors that extra fundraising efforts need to be addressed. Lisa adds a separate paragraph at the end of her auditor's report stating the financials are to be used only for these two purposes.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

31. Which of the following is an accounting basis that is considered an OCBOA per SAS No. 62? (Page 195)

- a. Liquidation Basis. [This answer is incorrect. The liquidation basis of accounting presents assets at amounts expected to be realized in liquidation and liabilities at amount expected to be paid to creditors. It is not mentioned as an OCBOA in SAS No. 62.]
- b. **Tax Basis. [This answer is correct. Both SAS No. 62 and SSARS No. 1 include the cash, tax and regulatory basis as examples of OCBOAs.]**
- c. Agreed-upon Basis. [This answer is incorrect. The agreed-upon basis of accounting is not considered an OCBOA per SAS No. 62. The agreed-upon basis measures assets and liabilities as prescribed in an agreement or contract.]
- d. Fair Value Basis. [This answer is incorrect. The fair value basis falls under the SFAS No. 157, Fair Value Measurements. The fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It is not mentioned as an OCBOA in SAS No. 62.]

32. Which of the following scenarios follows the appropriate steps based on the use of the report? (Page 199)

- a. John is hired to audit the financial statements of commercial contractor, HB and Sons, whose only customer is the State of Texas. HB and Sons produces their financial statements as regulatory-basis statements using the cash basis of accounting and plans to use the financial statements to apply for a loan with Bank of Houston. John reviews the financial statements and issues them without modifying the auditor's report. [This answer is incorrect. The financial statements were generated on an OCBOA and intended for other uses, so John should have modified the standard form of the auditor's report prescribed by SAS No. 58 for any material GAAP departures arising from the use of the regulatory basis.]
- b. Steve is engaged to audit Little Elm Fire department. The department is applying to the state for additional governmental funds to do more extensive training with their employees. The financial statements are produced on the regulatory-basis as OCBOA financial statements, but did not have any material departures from GAAP. Steve expresses an adverse opinion on the audit because the statements were not GAAP, but OCBOA. [This answer is incorrect. Steve only has to issue an adverse opinion on the financial statements if the department was using the financial statements for more than one intended use and the financial statements had any material GAAP departures arising from the use of the regulatory basis.]
- c. **Sally audits a balance sheet for Hanson Insurance Company to be submitted to the state regulatory agency. The financial statements were prepared on a regulatory-basis. Sally included in the auditor's report a separate paragraph that the report is intended solely for the state regulatory agency and should not be used by anyone other than the specified party. [This answer is correct. Since the insurance company prepared the financial statements to be submitted to the state regulatory agency and it was specified that the report was intended solely for the agency's use in the auditor's report, compliance with SAS No. 62 was achieved.]**
- d. Lisa is employed by Little Angels, a nonprofit agency, to do an audit of their OCBOA financial statements that are produced on a regulatory-basis. The nonprofit is going to use the financial statements to apply with the federal government for a grant and to show contributors that extra fundraising efforts need to be addressed. Lisa adds a separate paragraph at the end of her auditor's report stating the financials are to be used only for these two purposes. [This answer is incorrect. If the financials are produced on a regulatory basis on an OCBOA and a paragraph is added to the auditor's report, then the information should only be used by a regulatory agency. Little Angels cannot use the financial statements for fundraising efforts and be in compliance with SAS No. 62.]

REGULATORY BASIS

Regulated companies must report financial information to the federal, state, or local government agencies that regulate them. Often, the basis of accounting used to report to those agencies (referred to as the regulatory basis) differs from GAAP because of unique reporting requirements related to the regulatory process. For example, to obtain information about an insurance company's ability to pay claims in the future, a state regulatory agency may require insurance companies to report certain balance sheet accounts on a liquidation basis rather than on a going concern basis. SAS No. 62 allows auditors to report on regulatory basis financial statements as OCBOA financial statements only if the statements and auditors' report are intended solely for filing with the regulatory agencies to which the entity is subject. If the financial statements and auditors' report are not limited to use in regulatory filings, the auditors must report on the statements as GAAP financial statements containing GAAP departures.

Regulatory basis financial statements are prepared by many types of entities, including insurance companies, credit unions, construction contractors, certain state and local governmental entities, and some nonprofit organizations. The following paragraphs discuss disclosure and reporting considerations for the regulatory basis of accounting, common uses of the regulatory basis of accounting by those entities, regulatory reporting requirements that are considered GAAP, and distinguishing the regulatory basis of accounting from a contractual basis.

Disclosure Considerations for the Regulatory Basis

The disclosure requirements under the regulatory basis of accounting are not as well defined as they are under GAAP. Guidance on disclosures in regulatory basis financial statements is found in the auditing literature—SAS No. 62 (AU 623.09–.10) and Interpretation 14 of SAS No. 62 (AU 9623.90–.95). SAS No. 62 requires regulatory basis financial statements to disclose the basis of the presentation and how it differs from GAAP, and to include informative disclosures appropriate for the basis of accounting. It adds that disclosures similar to GAAP should be made when OCBOA financial statements contain items similar to GAAP financial statements and that the need for disclosures related to matters not specifically identified on the face of the statements should be considered. Interpretation 14 of SAS No. 62 clarifies the guidance in the SAS and generally requires regulatory basis financial statements to either follow the relevant GAAP disclosure requirements or provide information that communicates the substance of those GAAP requirements.

Reporting on Regulatory Basis Financial Statements

The appropriate form of regulatory basis report depends on the use of the report. If the entity's regulatory basis financial statements will be used solely for filing with a governmental regulatory agency to whose jurisdiction the entity is subject, SAS No. 62 allows auditors to report on the regulatory-basis statements as OCBOA financial statements. In that case, the auditors' report should include a separate paragraph at the end of the report stating that the report is intended solely for the information and use of those within the entity and the regulatory agencies to whose jurisdiction the entity is subject, and is not intended to be and should not be used by anyone other than these specified parties. If an entity's regulatory basis financial statements are intended for other uses, SAS No. 62 requires auditors to modify the standard form of auditors' report prescribed by SAS No. 58 for any material GAAP departures arising from the use of the regulatory basis. After expressing a qualified or adverse opinion as to conformity with GAAP, auditors may express an opinion on whether the statements are presented in conformity with the regulatory basis of accounting.

Interpretation No. 15 of SAS No. 62, *Auditor Reports on Regulatory Accounting or Presentation When the Regulated Entity Distributes the Financial Statements to Parties Other Than the Regulatory Agency Either Voluntarily or Upon Specific Request* (AU 9623.96–.98), confirms that this type of reporting is required when:

1. the financial statements and report are intended for use by parties other than those within the entity and one or more regulatory agencies to whose jurisdiction the entity is subject, or
2. the financial statements and report are distributed (either voluntarily or upon specific request) by the entity to parties other than the regulatory agencies to whose jurisdiction the entity is subject.

Although Interpretation 15 applies to all regulated entities, the interpretation specifically mentions certain state and local governmental entities that prepare financial statements under the requirements of a governmental regulatory agency.

The AICPA Audit and Accounting Guide, *State and Local Governments*, Paragraph 15.10, provides similar guidance regarding Interpretation 15. Paragraph 15.10 notes that in situations where the regulatory basis financial statements are intended for general-purpose use, the auditors should consider such financial statements and the accompanying auditor's report to be available for public distribution. In that case, the auditor should follow the guidance in AU 544, *Lack of Conformity With Generally Accepted Accounting Principles*, and modify the report for lack of conformity with GAAP. In addition, that report may also include an appropriate opinion on whether the financial statements are presented in conformity with the regulatory requirements.

Legislative Developments on Regulatory Bases of Accounting. The Texas legislature, in its 2007 session, established a basis of accounting other than generally accepted accounting principles for Texas and its political subdivisions. Sections 2264.052 and 2264.053 of the statute state—

- In this state, a statutory modified accrual basis qualifies as an other comprehensive basis of accounting that recognizes revenue when it is measurable and available to finance current expenditures, and recognizes expenditures when they are normally expected to be liquidated with current financial resources regardless of when they mature.
- This state and its political subdivisions may account for and report selected types of financial activities on a statutory modified accrual basis for government-wide and fund-level internal and external financial statement reporting.
- Compliance with the statutory accounting principles by this state or a political subdivision satisfies any other law that requires accounting and reporting according to generally accepted accounting principles.

The only specific measurement guidance the statute provides for the statutory modified accrual basis of accounting is an optional departure from generally accepted accounting principles to account for postemployment benefits on the pay-as-you-go method instead of the method required by GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. Section 2264.102 of the statute says—

To the extent that generally accepted accounting principles require accounting or reporting of other postemployment benefits at the government-wide or fund level on any basis other than pay-as-you-go, this state and its political subdivisions may account for or report those other postemployment benefits in accordance with the statutory accounting principles in this chapter.

Section 2264.104 of the statute prescribes disclosures about postemployment benefits other than pensions, and Section 2264.105 permits specified additional optional disclosures “for informational and planning purposes only and in a manner consistent with this subchapter” about “the expense and liability that would exist if other postemployment benefits had been guaranteed to members.”

For those governmental entities that choose to not implement GASBS No. 45 but instead follow the regulatory accounting method allowed by the statute, auditors will be faced with the need to issue a modified opinion due to the GAAP departure if the reports will be distributed to others outside of the entity or the regulatory agency. See the discussion of Interpretation 15 of AU 623 earlier in this lesson.

A somewhat similar proposal was introduced into the 2007 session of the Connecticut legislature. The proposal, H. B. No. 7338, would have allowed “the Comptroller to define GAAP accounting standards.” It was approved by the House and the Senate but vetoed by the Governor in July 2007.

Statutory Accounting Practices Used by Insurance Companies

The statutory basis of accounting used by an insurance company for filing financial reports with a state regulatory authority is one of the most common examples of the regulatory basis of accounting. Regulatory authorities in each state generally require insurance companies licensed to do business in the state to file with the state insurance

commissioner an Annual Statement (which presents the company's financial information as of December 31 of the current and preceding year) and audited statutory basis financial statements. The accounting principles and practices prescribed by state insurance departments are referred to as the "statutory" basis of accounting because of the legislative authority from which many of the practices have evolved. The statements are prepared using statutory accounting practices (SAP), which vary between states. Statutory accounting practices currently consist of the accounting principles and practices prescribed or permitted by each state's regulatory authority. Prescribed statutory accounting practices are practices incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state.

Statutory accounting practices also include permitted practices allowed by each state regulatory authority. Insurance companies can request permission from state regulatory authorities to use a specific accounting practice that departs from a prescribed practice or that addresses the accounting for a particular transaction not covered by prescribed practices. Consequently, permitted practices may differ from state to state, as well as from company to company within a state. Prescribed or permitted statutory accounting practices currently are considered an OCBOA.

NAIC Codification Project. In 1999, the National Association of Insurance Commissioners (NAIC) codified statutory accounting principles for certain insurance enterprises, resulting in a revised *NAIC Accounting Practices and Procedures Manual*, effective January 1, 2001. The NAIC was organized by the state insurance commissioners to promote more uniform regulation of insurance companies between the states. The NAIC continually monitors SAP for insurance companies and recommends changes in statutory accounting and reporting to state insurance departments. Although the NAIC's decisions are not binding on any of the state insurance commissioners, state insurance departments generally adopt NAIC "model statutes" or regulations. Most states require insurance enterprises domiciled in those states to follow the revised Manual, except as prescribed or permitted by state law. (If the state laws, regulations, and administrative rules differ from the Manual, those state laws, regulations and administrative rules take precedence.) Practitioners should monitor the status of the adoption of the revised Manual by the various state regulatory authorities. Practitioners should also monitor changes to the NAIC manual. For further information on this project, practitioners may access the NAIC's website at www.naic.org.

Primary Differences between GAAP and SAP. The primary emphasis of SAP is on demonstrating the solvency (i.e., the ability to pay claims in the future) of insurance companies to state regulators. Consequently, SAP financial statements present many balance sheet accounts on a liquidation basis rather than a going-concern basis. Significant differences between GAAP and SAP are discussed in the AICPA Audit and Accounting Guide, *Property and Liability Insurance Companies*.

Disclosures in Statutory Financial Statements. Most states are expected to adopt the NAIC's revised Manual, which contains extensive disclosure requirements. Therefore, after a state adopts the revised Manual, its statutory basis of accounting will include the disclosures appropriate for that basis of accounting. However, some states may not adopt the revised Manual or may adopt it with significant departures. Interpretation No. 14 of SAS No. 62, *Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)*, provides guidance on disclosures in regulatory basis financial statements. In addition, Interpretation No. 12, *Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis* (AU 9623.60–.77), provides guidance on disclosures in statutory basis financial statements of insurance entities. SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*, amended this auditing interpretation along with SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*, SOP 95-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises* (FASB ASC 944), and SOP 94-1, *Inquiries of State Insurance Regulators*. In January 2005, Interpretation No. 12 was again revised. The revision noted that Interpretation No. 14 applies to all OCBOA presentations and that Interpretation No. 12 provides additional guidance on informative disclosures for the statutory basis financial statements of insurance enterprises. The Interpretation references Paragraphs .09 and .10 of SAS No. 62, which state that financial statements prepared on an OCBOA should "include all informative disclosures that are appropriate for the basis of accounting used," including a "summary of significant accounting policies that discusses the basis of presentation and describes how that basis differs from generally accepted accounting principles." (The effects of such differences need not be

quantified.) The Interpretation provides the following guidance in applying SAS No. 62's disclosure requirements to statutory basis financial statements:

- Statutory basis financial statement disclosures should be the same as, or similar to, GAAP disclosures for items and transactions that are accounted for “essentially the same or in a similar manner” under the statutory basis as under GAAP unless the revised Manual specifically states the NAIC Codification rejected the GAAP disclosures. Disclosures required by the revised Manual should also be included.
- Disclosures for items or transactions accounted for in accordance with the revised Manual but that differ from GAAP, should be the disclosures required by the revised Manual.
- If the state's required accounting for an item or transaction differs from the accounting in the revised Manual, but is in accordance with GAAP or superseded GAAP, the statutory basis financial statement disclosures for that item or transaction should be the applicable GAAP or superseded GAAP disclosures.
- If the accounting required by the state for an item or transaction differs from the accounting in the revised Manual, GAAP, or superseded GAAP, sufficient relevant disclosures should be made.
- The auditor should consider whether disclosures are needed for matters not specifically identified on the face of statutory basis financial statements (such as related party transactions, subsequent events, uncertainties, and restrictions on assets and owners' equity) and any other matters necessary to keep the financial statements from being misleading.
- Clarifies that new GAAP disclosure requirements not yet adopted by the NAIC should still be followed as required by AU 623.

The unique statutory accounting practices allowed by each state regulatory authority are referred to as *permitted* practices, and practices that are incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state are referred to as *prescribed* practices. SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises* (FASB ASC 944-505-50-2), as amended, requires the disclosures described in the following paragraph if both of the following conditions are met:

- a. State-prescribed statutory accounting practices differ from NAIC statutory accounting practices, or permitted state statutory accounting practices differ from either state, prescribed statutory accounting practices or NAIC statutory accounting practices, and
- b. The use of prescribed or permitted statutory accounting practices (individually or in the aggregate) results in the insurance enterprise reporting statutory surplus or risk-based capital that is significantly different from the statutory surplus or risk-based capital that the enterprise would have reported under NAIC statutory accounting practices.

At the date each financial statement is presented, SOP 94-5 (FASB ASC 944-505-50-3) states that insurance enterprises should disclose a description of the prescribed or permitted statutory accounting practice and the related monetary effect on statutory surplus of using an accounting practice different from either state prescribed statutory accounting practices or NAIC statutory accounting practices. FASB ASC 944-505-50-6 states that the entity should also disclose whenever an insurance enterprise's risk-based capital would have triggered a regulatory event had it not used a permitted practice (FASB ASC 944-505-50-6).

The following is an example note disclosure, based on an illustration in SOP 94-5 (FASB ASC 944-505-1), and paragraph 4.134 of the AICPA Audit and Accounting Guide, Property and Liability Insurance Companies:

NOTE X—STATUTORY ACCOUNTING PRACTICES

The Company's statutory financial statements are presented on the basis of accounting practices prescribed or permitted by the [State of domicile] Insurance Department. [State of domicile] has adopted the National Association of Insurance Commissioners' statutory accounting practices

(NAIC SAP) as the basis of its statutory accounting practices, except that it has retained the prescribed practice of writing off goodwill immediately to statutory surplus in the year of acquisition.

In addition, the commissioner of [State of domicile] Insurance Department has the right to permit other specific practices that may deviate from prescribed practices. The commissioner has permitted the Company to record its home office property at estimated fair value instead of at depreciated cost, as required by NAIC SAP. This accounting practice increased statutory capital and surplus by \$1.9 million and \$1.7 million at December 31, 20X2 and 20X1, respectively, over what it would have been had the permitted practice not been allowed. The Company's statutory capital and surplus, including the effects of the permitted practice, was \$25.5 million and \$23.9 million at December 31, 20X2 and 20X1, respectively.

Had the Company amortized its goodwill over ten years and recorded its home office property at depreciated cost, in accordance with NAIC SAP, the Company's capital and surplus would have been \$25.4 million and \$23.7 million at December 31, 20X2 and 20X1, respectively.

SOP 94-5 (FASB ASC 944-40-50-3) requires financial statements to disclose the following information about the liability for unpaid claims and claim adjustment expenses for each fiscal year for which an income statement is presented:

1. The beginning and ending balances in the liability for each fiscal year presented, and the related amount of reinsurance recoverable
2. Incurred claims and claim adjustment expenses, with separate disclosure of the provision for current year insured events and changes in the provision for prior years' insured events
3. Payments of claims and claim adjustment expenses, with separate disclosure of payments attributable to current year insured events and prior years' insured events

The liability for unpaid claims and claim adjustment expenses includes the estimated amount of future payments for (a) claims that have been reported to the insurer, (b) claims that have been incurred but not reported as of the balance sheet date, and (c) claim adjustment expenses (e.g., legal fees, outside adjuster fees, and costs for recording, processing, and adjusting claims).

Insurance companies also should disclose the reasons for the change in incurred claims and claim adjustment expenses recognized in the income statement attributable to prior years' insured events and indicate whether additional premiums or return premiums have been accrued as a result of the prior-year effects. In addition, SOP 94-5 (FASB ASC 944-40-50-4) states that management's policies and methods for estimating the liability for unpaid claims and claim adjustment expenses that are difficult to estimate (such as claims for toxic waste cleanup or asbestos-related illnesses) should be disclosed.

Reporting on Statutory Financial Statements. The appropriate form of regulatory basis report depends on the use of the reports. If an insurance company's statutory financial statements will be used solely for filing with state regulatory authorities to whose jurisdiction the company is subject, SAS No. 62 allows auditors to report on the statutory statements as OCBOA financial statements. In that case, the auditors' report must contain a statement that restricts the use of the statutory basis financial statements to those within the insurance company and for filing with the state regulatory authorities to whose jurisdiction the company is subject. If an insurance company's statutory financial statements are intended for use other than for filing with the state regulatory authorities to whose jurisdiction the company is subject, SAS No. 62 requires auditors to modify the standard form of auditors' report prescribed by SAS No. 58 for any material GAAP departures relating to the statutory basis. After expressing a qualified or adverse opinion as to conformity with GAAP, auditors may express an opinion on whether the statements are presented in conformity with statutory accounting practices.

Chapter 8 of the AICPA Audit and Accounting Guide, *Property and Liability Insurance Companies* (the AICPA's Insurance Guide), as amended by SOP 01-5 (FASB ASC), provides further guidance on applying SAS No. 62's and

No. 58's reporting requirements to audited statutory basis financial statements filed with state regulatory authorities. The guidance in that chapter states that—

- Differences between statutory accounting practices and GAAP generally relate to significant financial statement items and typically are material and pervasive to most insurance companies' financial statements. Therefore, general-use auditors' reports should express an adverse opinion with respect to conformity with GAAP, unless the differences between statutory accounting practices and GAAP are not material and pervasive.
- Although auditing standards do not prohibit issuing general-use and limited-use reports on the same statutory financial statements, paragraph 8.32 of the AICPA's Insurance Guide states a preference for issuing only one of those types of reports.
- As required by SAS No. 62, the notes to the statutory financial statements should include a summary of significant accounting policies that discuss statutory accounting practices and describe how the basis differs from GAAP. If the statutory financial statements are for general use, the effects of the differences should be disclosed, if quantified. If the statutory financial statements are for limited use, the effects of the differences do not need to be disclosed or quantified.
- The need for an explanatory paragraph in the auditors' report should be considered regardless of the report's distribution, the opinion expressed, or whether the auditor is reporting on conformity with GAAP or with statutory accounting practices. For example, if there is substantial doubt about an insurance company's ability to continue as a going concern, an explanatory paragraph should follow the second opinion paragraph in a general-use auditors' report that expresses both an opinion as to conformity with GAAP and an opinion as to conformity with the statutory accounting practices.
- The addition of an "emphasis-of-a-matter" paragraph to the auditors' report is strongly encouraged when statutory basis financial statements include significant transactions that are reported using permitted statutory accounting practices that materially affect the insurance company's statutory capital. The "emphasis-of-a-matter" paragraph should describe the permitted practices and their effects on statutory capital.
- If, after initially adopting the revised Manual, a change in accounting principles or the method of application materially affects the comparability of the company's financial statements, the auditor should refer to the change in an explanatory paragraph. This paragraph, which follows the opinion paragraph, should identify the nature of the change and refer to the note that discusses the change. The auditor is assumed to concur with the change, unless the auditor takes exception to the change in expressing the opinion as to the fair presentation of the financial statements in conformity with GAAP or the statutory accounting practices.

Regulatory Accounting Practices Used by Financial Institutions

Banks and Savings Institutions. Federal regulations require insured banks and savings institutions to file quarterly Federal Financial Institutions Examination Council (FFIEC) Consolidated Reports of Condition and Income and Office of Thrift Supervision (OTS) Thrift Financial Reports (collectively referred to as "call reports"). Call reports contain certain financial information, including the amounts used to calculate regulatory capital. Prior to March 1997, banks and savings institutions prepared call reports using regulatory accounting practices (RAP). However, the FFIEC adopted GAAP effective with the March 1997 call reports. Therefore, banks and savings institutions no longer should have GAAP-RAP differences.

Credit Unions. Credit unions with less than \$10 million in assets may sometimes wish to present their financial statements using RAP (credit unions with \$10 million or more in assets *must* present their financial statements using GAAP). In this situation, the AICPA Audit and Accounting Guide, *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies* (Depository and Lending Institution Audit Guide), indicates that RAP constitutes an OCBOA, and auditors can report on RAP financial statements in accordance with SAS No. 62. As required by SAS No. 62 for regulatory basis financial statements reported on as an OCBOA, the auditors' report should include a restricted use paragraph and be used only if the regulatory basis financial statements are intended solely for filing with the applicable regulatory agency.

Appendix B of the Depository and Lending Institution Audit Guide identifies some of the differences between GAAP and RAP for credit unions. Other differences may result from RAP requirements for reclassifications of amounts within regulatory financial reports. The Depository and Lending Institution Audit Guide points out that “certain differences between RAP and GAAP amounts as computed for regulatory and general purpose reporting, respectively, may warrant consideration by the independent accountant.”

In some situations, credit unions with less than \$10 million in assets may wish to present GAAP financial statements except for the presentation of members' share accounts. In those situations, share accounts are presented in the equity section of the statement of financial condition, rather than as liabilities as required by GAAP. Other credit unions choose not to distinguish liabilities from equity in their statements of financial condition and present share accounts immediately above undivided earnings. If share accounts are not clearly designated as liabilities in GAAP financial statements, the auditors should express either a qualified or adverse opinion on the GAAP statements (except for the rare situations in which share accounts are immaterial).

Construction Contractors

Some governmental agencies (such as state highway departments) require contractors to file prequalification reports to qualify for bidding on, or performing work for, the agency. The contractor prequalification filings frequently are preprinted forms that include both an accountants' report and financial information. Typically, the financial information consists of a balance sheet and accompanying schedules. However, the forms may require full financial statements or require that financial information be attached. The prequalification reports generally request that contractors provide GAAP financial information; however, some states have developed detailed accounting requirements that are not in accordance with GAAP and can be considered a regulatory basis of accounting. SAS No. 62 allows auditors to report on the regulatory basis statements as OCBOA financial statements. In that case, the report should include a restricted use paragraph and be used only if the regulatory basis financial statements are intended solely for filing with the applicable regulatory agency. If the report is not limited to use in regulatory filings, SAS No. 62 requires auditors to modify the standard form of auditors' report prescribed by SAS No. 58 for any material GAAP departures relating to the regulatory basis.

As noted in the previous paragraph, state prequalification forms generally require the contractor to provide GAAP financial information. However, many of the prequalification forms do not ask for or require GAAP disclosures. In that case, any omitted disclosures should be attached to the prequalification form. The attachment normally takes the form of notes to the financial statement(s). Since a qualified or adverse auditors' opinion for omitted disclosures may adversely affect the qualification process, best practices suggest that all GAAP disclosures not included in the preprinted filing form be attached. GAAP financial statements that do not include all of the required financial statement disclosures because the regulatory agency does not require the disclosures should not be considered regulatory basis (OCBOA) statements.

The filing forms in some states include “schedules” that include much of the information required by GAAP. Some auditors report on those schedules as supplementary information while others report on the information as part of the balance sheet. The advantage of reporting on the schedules as part of the balance sheet is that including the information in the schedules meets GAAP disclosure requirements. If the schedules are reported on as supplementary information, the same disclosures must be attached in the notes to the balance sheet.

IRS Form 990

Some states allow charitable organizations to use IRS Form 990 (Return of Organizations Exempt from Income Tax), as a uniform annual report for reporting to both state and federal governments. In December 2007, the IRS released a redesigned Form 990 for tax year 2008 (to be filed in 2009 and later years), and in August 2008, the IRS released revised instruction for the form. Some of those states require Form 990 to be accompanied by an auditors' report on the financial statements included in the form. The type of auditors' report depends on (a) whether the financial statements presented in Form 990 are in conformity with GAAP and (b) the report's use. When financial statements presented on Form 990 contain GAAP departures required by a state agency, the financial statements can be reported on as regulatory basis statements only if they are intended solely for filing with the regulatory agency and the auditors' report includes a restrictive use paragraph. If Form 990 will be used for purposes other than regulatory filings (for example, copies of the Form 990 are distributed to and used by contributors or others), auditors should express a qualified or adverse opinion on the statements if they are not in conformity with GAAP. In

addition, according to Interpretation No. 14 of SAS No. 62 (AU 9623.90–.95), separate financial statements based on the financial information included in Form 990 can be reported on as income tax basis, rather than regulatory or GAAP basis statements.

Regulatory Basis May Be GAAP

As discussed in the previous paragraphs, the financial statements of many regulated companies may differ from GAAP. However, many other regulated operations are covered by GAAP. For example, the guidance in SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation* (FASB ASC 980-10), applies to most public utilities and other enterprises that have regulated operations and meet all of the following criteria (FASB ASC 980-10-15-2):

- An independent, third-party regulator, or the enterprise's own appropriately empowered governing board, establishes or approves the enterprise's rates for regulated services or products provided to its customers.
- The regulated rates are designed to recover the specific enterprise's costs of providing the regulated services or products.
- In view of the demand for the regulated services or products and the level of competition, rates set at levels sufficient to recover the enterprise's costs can be charged to and collected from customers.

SFAS No. 71 (FASB ASC 980-10) provides guidance on capitalizing costs, recording liabilities, capitalizing an "allowance for funds used during construction," and accounting for intercompany profit.

In addition, regulated enterprises should consider the following when accounting for plant abandonments, cost disallowances for recently completed plants, phase-in plans, and discontinuance of regulated operations:

- SFAS No. 90, *Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs* (FASB ASC 980-360)
- SFAS No. 92, *Regulated Enterprises—Accounting for Phase-in Plans* (FASB ASC 980-340)
- SFAS No. 101, *Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71* (FASB ASC 980-20)

The accounting specified in the FASB ASC for a regulated entity is GAAP for that particular entity, even though such accounting may not be GAAP for nonregulated entities. Therefore, if a regulated entity's financial statements are prepared using the accounting principles specified by GAAP, that entity's financial statements should be considered GAAP rather than regulatory basis statements.

Regulatory Basis versus Contractual Basis

Regulated enterprises may be asked to prepare financial statements on a basis of accounting prescribed in a contract or other agreement that results in a presentation that is not in conformity with GAAP or the regulatory basis. Financial statements prepared in conformity with a contractual basis that does not meet SAS No. 62's definition of the regulatory basis should not be treated as regulatory basis statements. Auditors should report on the conformity of such statements with the contractual basis following the guidance in SAS No. 62 at AU 623.27–.30 for special-purpose financial statements. The auditors' report should:

1. explain what the presentation is intended to present and refer to the note to the special-purpose financial statements that describes the basis of presentation,
2. state that the presentation is not intended to be in conformity with GAAP,
3. describe any significant interpretations made by management relating to the provisions of the agreement, and
4. state that the report is intended solely for the information and use of those within the entity, the parties to the agreement, the regulatory agency with which the report is being filed, or those with whom the entity is

negotiating directly and is not intended and should not be used by anyone other than those specified parties (that is, those individuals who have an opportunity to ask the entity questions about the presentation).

Interpretation 28 of SSARS No. 1, *Special-Purpose Financial Statements to Comply with Contractual Agreements or Regulatory Provisions*, (AR 9100.109–.110) contains guidance similar to SAS No. 62 for accountants engaged to compile or review special-purpose financial statements that are not in conformity with GAAP or an OCBOA but are prepared on the basis of accounting specified in an agreement.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

33. Which of the following is guidance that should be applied regarding SAS No. 62's disclosure requirements in relation to Interpretation No. 14 to statutory basis financial statements for the insurance industry?
- a. If GAAP disclosure requirements have not yet been adopted by the National Association of Insurance Commissioners (NAIC), then there is no obligation to adhere to the guidance.
 - b. Disclosures are required, even if the issue is not specifically identified on the face of the statutory basis financial statements.
 - c. If an item is accounted for in accordance with the revised NAIC Manual, but differs from GAAP, the disclosures should be done in accordance with GAAP.
 - d. Disclosures should be the same as GAAP for statutory financial statements for items and transactions that are accounted for in the same manner as GAAP.
34. For an insurance company, which is required to be included about liabilities for unpaid claims and claim adjustment expenses for each fiscal year for which an income statement is presented?
- a. The beginning balance must be reported, but the ending does not, since it is a moving target.
 - b. The amount of reinsurance recoverable related to the liabilities in the fiscal year presented.
 - c. All incurred claims and claim adjustment expenses must be detailed, but no other separate disclosure is required.
 - d. Claim adjustment expenses should be included in the income statement, but payments of claims should be accrued until the entire claim has been resolved.
35. SOP 95-5 provides further guidance in applying SAS No. 62 and No. 58 on reporting requirements. The direction of SOP 95-5 requires the auditor to perform which of the following steps?
- a. Add notes to the statutory financial statements that include a summary of significant accounting policies that discuss statutory accounting practices.
 - b. Issue both general-use and limited-use reports on the all statutory financial statements.
 - c. Express an adverse opinion if the statutory accounting practices are followed instead of GAAP.
 - d. Add an explanatory paragraph to the auditor's report if the report is going to be distributed widely.
36. Sometimes, regulated enterprises are asked to prepare financial statements on an accounting basis prescribed in a contract. These special-purpose financial statements require consideration by the auditor in the report. The report should include which of the following?
- a. Explain that although the financial statements are prepared in an alternate manner, they are general-use financial statements.
 - b. A note from the auditor explaining that the financial statements were not prepared in accordance with GAAP, but does not have to pinpoint which basis was used.
 - c. A statement that the financial statements were not intended to be in conformity with GAAP.
 - d. A paragraph detailing all interpretations made by management to apply the special-purpose basis of accounting.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

33. Which of the following is guidance that should be applied regarding SAS No. 62's disclosure requirements in relation to Interpretation No. 14 to statutory basis financial statements for the insurance industry? **(Page 201)**
- a. If GAAP disclosure requirements have not yet been adopted by the National Association of Insurance Commissioners (NAIC), then there is no obligation to adhere to the guidance. [This answer is incorrect. Even if the NAIC has not yet adopted the new GAAP disclosure requirements, they should still be followed as required by AU 623.]
 - b. Disclosures are required, even if the issue is not specifically identified on the face of the statutory basis financial statements. [This answer is incorrect. The auditor should consider whether disclosures are needed for matters not specifically identified on the face of statutory basis financial statements and any other matters necessary to keep the financial statements from being misleading.]
 - c. If an item is accounted for in accordance with the revised NAIC Manual, but differs from GAAP, the disclosures should be done in accordance with GAAP. [This answer is incorrect. Disclosures for items or transactions accounted for in accordance with the revised Manual but that differ from GAAP, should be disclosures required by the revised Manual.]
 - d. **Disclosures should be the same as GAAP for statutory financial statements for items and transactions that are accounted for in the same manner as GAAP. [This answer is correct. Statutory basis financial statement disclosures should be the same as, or similar to, GAAP disclosures for items and transactions that are accounted for "essentially the same or in a similar manner" under the statutory basis as under GAAP.]**
34. For an insurance company, which is required to be included about liabilities for unpaid claims and claim adjustment expenses for each fiscal year for which an income statement is presented? **(Page 203)**
- a. The beginning balance must be reported, but the ending does not, since it is a moving target. [This answer is incorrect. Both the beginning and ending balances in the liability must be reported for each fiscal year presented in the income statement.]
 - b. **The amount of reinsurance recoverable related to the liabilities in the fiscal year presented. [This answer is correct. The financial statements should disclose the beginning and ending balances in the liability for each fiscal year presented, and the related amount of reinsurance recoverable.]**
 - c. All incurred claims and claim adjustment expenses must be detailed, but no other separate disclosure is required. [This answer is incorrect. It is required that incurred claims and claim adjustment expenses be included in the income statements presented, with separate disclosure of the provision for current year insured events and changes in the provision for prior year's insured events.]
 - d. Claim adjustment expenses should be included in the income statement, but payments of claims should be accrued until the entire claim has been resolved. [This answer is incorrect. The income statement for each fiscal year presented should include payments of claims and claim adjustment expenses, with separate disclosure attributable to current year insured events and prior years' insured events.]
35. SOP 95-5 provides further guidance in applying SAS No. 62 and No. 58 on reporting requirements. The direction of SOP 95-5 requires the auditor to perform which of the following steps? **(Page 203)**
- a. **Add notes to the statutory financial statements that include a summary of significant accounting policies that discuss statutory accounting practices. [This answer is correct. The auditor should add notes to the financial statements that address statutory accounting practices and how they differ from GAAP.]**

- b. Issue both general-use and limited-use reports on the all statutory financial statements. [This answer is incorrect. Although auditing standards do not prohibit issuing general-use and limited-use reports on the same statutory financial statements, the SOP states a preference for issuing only one of those types of reports.]
 - c. Express an adverse opinion if the statutory accounting practices are followed instead of GAAP. [This answer is incorrect. If the differences between the statutory accounting practices and GAAP relate to significant financial statement items and are material and pervasive, then an adverse opinion should be expressed. But, if the differences are not material and pervasive, then an adverse opinion does not have to be issued by the auditor.]
 - d. Add an explanatory paragraph to the auditor's report if the report is going to be distributed widely. [This answer is incorrect. The need for an explanatory paragraph in the auditor's report should be considered regardless of the report's distribution, the opinion expressed or whether the auditor is reporting on conformity with GAAP or with statutory accounting practices.]
36. Sometimes, regulated enterprises are asked to prepare financial statements on an accounting basis prescribed in a contract. These special-purpose financial statements require consideration by the auditor in the report. The report should include which of the following? **(Page 207)**
- a. Explain that although the financial statements are prepared in an alternate manner, they are general-use financial statements. [This answer is incorrect. The report should state that it is intended solely for the information and use of those within the entity, the parties of the agreement, the regulatory agency with which the report is being filed, or those with whom the entity is negotiating directly and is not intended and should not be used by anyone other than those specified parties.]
 - b. A note from the auditor explaining that the financial statements were not prepared in accordance with GAAP, but does not have to pinpoint which basis was used. [This is incorrect. The auditor's report should explain what presentation was intended and refer to the note to the special-purpose financial statements that described the basis of presentation.]
 - c. **A statement that the financial statements were not intended to be in conformity with GAAP. [This answer is correct. The auditor's report should include a statement that the presentation is not intended to be in conformity with GAAP.]**
 - d. A paragraph detailing all interpretations made by management to apply the special-purpose basis of accounting. [This answer is incorrect. The report only has to describe any significant interpretations made by management relating to the provisions of the agreement in the contract with the regulatory authority.]

OTHER BASES OF ACCOUNTING

Price-level Basis

The price-level basis of accounting is the only example of “a definite set of criteria having substantial support that is applied to all material items appearing in financial statements” explicitly mentioned in SAS No. 62. (It is not mentioned in the definition or examples of an OCBOA in AR 100.04, SFAS No. 89, *Financial Reporting and Changing Prices* (FASB ASC 255-10) only provides guidance for the presentation of *partial* price-level information (i.e., supplementary information), but FASB ASC 255-10-45-3 permits a comprehensive price-level presentation, to the extent such a presentation is not inconsistent with the historical cost/constant purchasing power accounting guidance in that Subtopic.

SFAS No. 89 (FASB ASC 255-10-50-1 through 50-10) encourages, but does not require, companies to disclose selected summarized information for each of the five most recent years as supplementary information to their primary financial statements. If presented, the amounts should be based on current, rather than historical, costs and adjusted for the effects of inflation using (a) average-for-the-year or end-of-the-year units of constant purchasing power or (b) dollars that have a purchasing power equal to that of dollars of the base period used by the Bureau of Labor Statistics in calculating the Consumer Price Index for All Urban Consumers (CPI-U). Additional disclosures about the current year are encouraged if certain of the amounts disclosed differ significantly from those reported in the primary financial statements. Historical cost financial statements that disclose supplementary information about the effects of changing prices, as encouraged by SFAS No. 89 (FASB ASC 255-10-50-1), are not OCBOA presentations. However, comprehensive price-level basis financial statements should be considered OCBOA presentations and prepared using the accounting guidance in SFAS No. 89 (FASB ASC 255-10).

The following summarizes the accounting guidance in SFAS No. 89 (FASB ASC 255-10-50-20 through 50-55) for measuring the effects of changing prices on certain financial statement items:

- **Inventory.** Inventory should be measured at the lower of current cost or recoverable amount. The current cost of inventory is the current cost to purchase or produce the goods. Various types of information may be used to determine those amounts. (For example, current costs may be measured based on current invoice prices or using externally or internally generated price indexes for the class of goods or services being measured.)
- **Property, Plant, and Equipment.** Property, plant, and equipment should be measured at the lower of current cost or recoverable amount of the assets' remaining service potential. The current cost of property, plant, and equipment is the current cost to acquire the assets' same service potential.
- **Net Sales and Other Operating Revenues.** Net sales and other operating revenues should be stated in units of constant purchasing power.
- **Income from Continuing Operations on a Current Cost Basis.** Income from continuing operations on a current cost basis equals income from continuing operations on a historical cost basis, except for the following:
 - Cost of goods sold should be measured at the lower of current cost or recoverable amount at the sale date or at the date on which resources are used on or committed to a specific contract (An asset's recoverable amount is the current worth of the net amount of cash expected to be received from the asset's sale or use.)
 - Depreciation, depletion, and amortization expense related to property, plant, and equipment should be based on the lower of the assets' recoverable amounts during the periods of use or the average current cost of acquiring the assets' same service potential.
 - Income tax expense should not be restated for the effects of temporary differences that may arise as a result of the use of current cost accounting methods.

- *Purchasing Power Gain or Loss on Net Monetary Items.* The purchasing power gain or loss on net monetary items is the net gain or loss determined by restating in units of constant purchasing power the beginning and ending balances of, and transactions in, monetary assets and monetary liabilities.
- *Increase or Decrease in the Lower of Current Cost or Recoverable Amount of Inventory and Property, Plant, and Equipment, Net of Inflation.* The increase or decrease in the current cost amounts of inventory and property, plant, and equipment is the difference between the current costs of the assets at their entry dates and exit dates for the year. (An asset's entry date for the year is the beginning of the year or the date it was acquired, whichever is applicable. Similarly, an asset's exit date is the end of the year or the date it was used or sold.)
- *Aggregate Foreign Currency Translation Adjustment on a Current Cost Basis, If Applicable.* For operations measured in a foreign functional currency, the effects of inflation on current costs are measured either by (a) translating amounts from the foreign currency to the U.S. dollar and restating the translated amounts based on the CPI-U (referred to as the "translate-restate" method) or (b) restating foreign currency amounts based on the functional currency's general price level index and translating the restated amounts to U.S. dollars (referred to as the "restate-translate" method). If the translate-restate method is used, the U.S. general price level index (i.e., the CPI-U) should be used to measure the effects of inflation. On the other hand, if the restate-translate method is used, the effects of inflation should be measured based on the general price level index of the functional currency.

The CPI-U used for each year's current cost/constant purchasing power calculations is updated monthly and may be obtained from the Department of Labor. If the CPI-U has not been published in time to prepare the financial statements, it may be estimated by referring to published economic forecasts or extrapolated based on recently reported changes in the index. Price-level basis financial statements should disclose the level of the CPI-U used for each year presented.

For companies operating in hyperinflationary economies in foreign countries, FASB ASC 255-10-45-2 states "that the degree of inflation or deflation in an economy may become so great that conventional statements lose much of their significance and general price-level statements clearly become more meaningful." The guidance goes on to point out that although this is obvious for circumstances of some countries, the degree of inflation or deflation at which general price-level statements clearly become more meaningful depends on the circumstances.

FASB ASC 255-10-15-2 notes that the guidance in the Changing Prices Topic only applies to statements prepared in the currency of the country in which the reported operations are conducted. Therefore, only conventional statements of foreign subsidiaries should be used to prepare historical-dollar consolidated financial statements.

Fair Value Basis

Is fair value an other comprehensive basis of accounting? The authoritative auditing literature and the authoritative compilation and review literature provide similar definitions of an other comprehensive basis of accounting.

- AU 623 provides four categories of other comprehensive bases of accounting. Fair value clearly would not fit into the first three categories—pure cash or modified cash basis, income tax basis, and regulatory basis—but the fourth category is a catch-all consisting of 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."
- SSARS No. 1 defines an other comprehensive basis of accounting as a "definite set of criteria, other than GAAP, having substantial support underlying the preparation of financial statements prepared pursuant to that basis."

Therefore, the answer to whether fair value is an other comprehensive basis of accounting depends on whether there is a definite set of criteria having substantial support for a comprehensive application of fair value measurements.

Three sources of authoritative guidance on fair value measurements look at comprehensive application, but each has a different perspective.

- a. SOP 82-1, *Accounting and Financial Reporting for Personal Financial Statements* (FASB ASC 274-10), looks at the fair values of individual assets and liabilities and derives the net worth of an individual by subtracting the fair value of the liabilities from the fair value of the assets.
- b. SFAS No. 141(R), *Business Combinations* (FASB ASC 805-10), starts with the consideration paid for an entity and looks at how to allocate the consideration to individual assets and liabilities based on their fair values.
- c. FIN 46(R), *Consolidation of Variable Interest Entities* (FASB ASC 810-10), estimates the fair value of the net assets of a variable interest entity without looking at individual assets and liabilities.

These different perspectives suggest the existence of a threshold question: What should net assets in a comprehensive application of fair values represent? Do they represent the fair value of the reporting entity or are they simply the residual of fair value measurements of individual assets and liabilities? As an observation, business valuations made for determining the fair value of an entity are determined using a variety of methods. For example, depending on the facts and circumstances, the method—

- a. may not look at the fair values of individual assets and liabilities,
- b. may only look at the fair values of some of the assets and liabilities, or
- c. may look at the fair values of all assets and liabilities.

Guidance on measuring individual assets and liabilities at fair value is provided in the authoritative accounting literature. For example—

- a. SOP 82-1 (FASB ASC 274-10) provides guidance on determining the fair values of assets and liabilities common to individuals.
- b. SFAS No. 157, *Fair Value Measurements* (FASB ASC 820-10), provides a framework for measuring fair value.

Different methods are discussed, but the appropriate method depends on the facts and circumstances. For example, depending on the facts and circumstances—

- a. the fair value of some assets may be determined using quoted prices in an active market,
- b. the fair value of some assets may be determined by discounting forecasted cash flows, and
- c. the fair value of some may be determined using replacement cost.

The application of any of the available measurement methods often requires significant judgment. For example—

- a. Measurement based on discounted long-term cash flows requires developing assumptions about future sources of cash flows and the likelihood that those cash flows will be realized.
- b. Even if a market exists for real estate, the location may be subject to uncertain market conditions that affect the fair value of the property.

There is little authoritative guidance on determining the income tax effect of unrealized appreciation and depreciation. For example, should it be measured assuming that the assets had been realized and the liabilities had been settled at the measurement date? That is the approach taken in SOP 82-1 (FASB ASC 274-10), but, while it may be a practical approach, it may not be a reasonable one. For example, the entity may have tax-planning strategies that would defer the realization and settlement dates.

Entities considering comprehensive fair value measurements ordinarily are thinking about financial position. However, there is also the possibility of presenting results of operations using fair value measurements. That raises a variety of questions. For example, how should the entity report the change in unrealized appreciation and depreciation? Should the entity report the net change as a single line item and, if so, how should it be reported? Or should changes be allocated to components of results of operations?

The FASB appears to be cautiously moving toward providing guidance on a comprehensive application of fair values. It was not that long ago that fair value guidance generally was provided only in the context of impairment. The FASB has since moved to—

- a. The continuing measurement of some assets and liabilities at fair value, such as some debt and equity securities and derivatives.
- b. The disclosure of fair values of financial instruments.
- c. The expanded guidance on fair value measurements required by existing generally accepted accounting principles.
- d. The option of electing to measure certain financial instruments at their fair value.

Financial presentations prepared using generally accepted accounting principles or an other comprehensive basis of accounting can include supplemental fair value information. For example—

- a. Financial statements prepared using generally accepted accounting principles could be presented in comparison with statements prepared using fair values.
- b. Financial statements prepared using the income tax basis of accounting could be accompanied by supplemental financial statements prepared using fair values.
- c. Financial statements prepared using generally accepting accounted principles could be accompanied by supplemental presentations of the fair values of selected items.
- d. Financial statements prepared using generally accepted accounting principles could include disclosures of fair values of selected items.

As a practical matter, accountants are probably better served by presenting fair value information as information supplementing financial information prepared using generally accepted accounting principles or another comprehensive basis of accounting. The absence of guidance on comprehensive applications of fair value measurements and the subjectivity of those measurements significantly increase the risk of misunderstanding stand-alone fair value presentations.

Even in supplemental presentations, the authors recommend disclosing information that will help the users understand how fair values were determined. The guidance in the existing authoritative accounting literature is helpful in developing those disclosures. For example, it will ordinarily be helpful to disclose how the fair value was determined and the significant assumptions underlying estimation techniques. It will also ordinarily be helpful to disclose assumptions that are highly subjective.

The guidance in the authoritative literature on forecasts and projections may also be helpful. For example, it may be helpful to disclose that fair value measurements were based on judgments at the time the fair value information was developed and to include a caveat that the fair values may not be realized.

Liquidation Basis

If the liquidation of an entity appears imminent, financial information may be prepared on the assumption that a liquidation will occur. An auditing interpretation at AU 9508.33–.37 states that a liquidation basis of accounting may be considered GAAP for entities in liquidation or for which liquidation appears imminent. Therefore, the liquidation basis of accounting is an OCBOA when it is used by a company that is *not* in liquidation or for which liquidation

does *not* appear imminent (for example, when management has the intention and capability of waiting for a certain price). Use of a liquidation basis of accounting for a going concern does not necessarily result in pro forma financial statements. Pro forma financial statements generally reflect the effect of one or a limited number of hypothetical transactions on a company's financial statements, whereas a liquidation basis of accounting is applied to all the items in the statements.

The liquidation basis usually involves reporting assets at net realizable values (i.e., the amounts of cash expected to be received). The resulting adjustments to record assets at market value trigger the recognition of gains and losses. In other words, gains and losses will be *recognized* in the financial statements before they are *realized*. When gains and losses are *realized*, an entry should be made debiting cash (or a receivable account), crediting the asset account, and recognizing an additional gain or loss if the amount realized from liquidation of the assets differs from the market value at the time the assets were converted to the liquidation basis.

The differences between the liquidation basis of accounting and the fair value basis of accounting can be subtle. The liquidation basis of accounting presents assets at amounts *expected to be realized in liquidation* and liabilities at amounts *expected to be paid to creditors*. Under the fair value basis of accounting, assets are presented at the *amounts at which they could be exchanged between well-informed and willing buyers and sellers* (that is, neither *compelled* to buy or sell) *at the date of the financial statements*, and liabilities are presented at the *discounted amount of cash to be paid*. Liquidation values sometimes are used as estimates of current value.

Agreed-upon Basis

Sometimes financial statements are prepared on a basis of accounting prescribed in an agreement that results in a presentation that is not in conformity with GAAP or an OCBOA. For example, a partnership agreement may require a special accounting treatment that conforms to neither GAAP nor tax accounting rules. Such an agreement may require undeveloped real property to be presented at appraisal value at the end of each year and developed real estate to be presented at 10 times the net cash flow from such property. Financial statements prepared in conformity with an agreed-upon basis that does not meet the definition of an OCBOA in SAS No. 62 or AR 100.04 should not be treated as OCBOA statements.

Auditors should report on the conformity of financial statements with an agreed-upon basis following the guidance in SAS No. 62 at AU 623.27–.30 for special-purpose financial statements. The auditors' report should (a) explain what the presentation is intended to present and refer to the note to the special-purpose financial statements that describes the basis of presentation, (b) state that the presentation is not intended to be in conformity with GAAP, (c) describe any significant interpretations made by management relating to the provisions of the agreement, and (d) restrict use of the report to those within the entity, the parties to the agreement, the regulatory agency with which the report is being filed, and those with whom the entity is negotiating directly (that is, those individuals who have an opportunity to ask the entity questions about the presentation).

Interpretation 28 of SSARS No. 1, *Special-Purpose Financial Statements to Comply with Contractual Agreements or Regulatory Provisions*, (AR 9100.109–.110) contains guidance similar to SAS No. 62 for accountants engaged to compile or review special-purpose financial statements that are not in conformity with GAAP or an OCBOA but are prepared on the basis of accounting specified in an agreement.

Prescribed Forms

Accountants may be engaged to report on financial information presented in prescribed forms or schedules. Prescribed forms include any *standard preprinted* form designed or adopted by the body to which it is to be submitted or filed. Examples include forms used by industry trade associations, credit agencies, banks, and governmental and regulatory bodies (other than those concerned with the sale or trading of securities). Tax returns are *not* considered prescribed forms. However, a form designed or adopted by the reporting entity is not considered a prescribed form. For example, a reporting package designed by a company for use in gathering financial statements for subsidiaries, divisions, or store locations is not a prescribed form. In addition, a comprehensive set of instructions not associated with a standard preprinted form does not constitute a prescribed form.

Determining the Basis of Accounting. If the prescribed form does not specify the accounting basis, the basis normally used by the company appears to be the most appropriate basis on which to prepare the financial

statements included in the form. For instance, a professional corporation that has adopted the cash basis of accounting should apply cash basis principles unless the form specifically requests otherwise. The authors suggest that when deciding which basis of accounting to use, the accountant weigh the objectives of the body prescribing the form, the difficulties of producing GAAP financial statements, and the special reporting considerations for OCBOA statements. For further guidance on prescribed forms, see *PPC's Guide to Compilation and Review Engagements*.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

37. Which of the following pronouncements discusses a framework for measuring fair value?
- a. SOP 82-1.
 - b. SFAS No. 157.
 - c. SFAS No. 141.
 - d. FIN 46.
38. Which of the following is not an appropriate method of applying fair value?
- a. Mike assigns a value to open futures on the balance sheet of the company based on current market pricing.
 - b. Merideth uses discounted forecasted cash flows for determining the value of the securities listed on the balance sheet.
 - c. Jack values a piece of machinery at his plant based on how much it would cost to replace it.
 - d. Since the company seems to be encountering financial problems, Amy values the land on the books based on what she could sell it to an interested competitor.
39. The difference between the liquidation basis and the fair value basis of accounting can be minute. Which of the following is a characteristic of the liquidation basis?
- a. Assets are valued at the amounts at which they could be sold between well-informed buyers and sellers.
 - b. Liabilities are priced at the amounts expected to be paid to creditors.
 - c. The discounted amount of cash to be paid is the presentation of the liabilities.
 - d. The assets should be valued at an amount that could receive on the open market, based on the company not being compelled to sale.
40. Which of the following would be considered a prescribed form?
- a. Tax return.
 - b. A preprinted form used to apply for a grant at a governmental agency.
 - c. The comprehensive instructions not associated with a preprinted form.
 - d. A reporting package designed by a parent company to collect information from its branches.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

37. Which of the following pronouncements discusses a framework for measuring fair value? **(Page 214)**

- a. SOP 82-1. [This answer is incorrect. SOP 82-1, *Accounting and Financial Reporting for Personal Financial Statements*, looks at the fair values of individual assets and liabilities and derives the net worth of an individual by subtracting the fair value of the liabilities from the fair value of the assets.]
- b. **SFAS No. 157. [This answer is correct. SFAS No. 157, *Fair Value Measurements*, provides a framework for measuring fair value.]**
- c. SFAS No. 141. [This answer is incorrect. SFAS No. 141, *Business Combinations*, starts with the consideration paid for an entity and looks at how to allocate the consideration to individual assets and liabilities based on their fair values.]
- d. FIN 46. [This answer is incorrect. FIN 46, *Consolidation of Variable Interest Entities*, estimates the fair value of the net assets of a variable interest entity without looking at individual assets and liabilities.]

38. Which of the following is **not** an appropriate method of applying fair value? **(Page 214)**

- a. Mike assigns a value to open futures on the balance sheet of the company based on current market pricing. [This answer is incorrect. One method of applying fair value is to use quoted prices in an active market.]
- b. Merideth uses discounted forecasted cash flows for determining the value of the securities listed on the balance sheet. [This answer is incorrect. Merideth employed a fair value method, which states that some asset's values may be determined by discounting forecasted cash flows.]
- c. Jack values a piece of machinery at his plant based on how much it would cost to replace it. [This answer is incorrect. Fair value may be determined using replacement cost.]
- d. **Since the company seems to be encountering financial problems, Amy values the land on the books based on what she could sell it to an interested competitor. [This answer is correct. This is not an example of a fair value method, but of liquidation basis. Liquidation basis usually involves reporting assets at net realizable values, for example the amount of cash expected to be received if the asset has to be sold.]**

39. The difference between the liquidation basis and the fair value basis of accounting can be minute. Which of the following is a characteristic of the liquidation basis? **(Page 216)**

- a. Assets are valued at the amounts at which they could be sold between well-informed buyers and sellers. [This answer is incorrect. If the assets are valued on the open market and not due to insolvency by the company, then they are valued at fair value.]
- b. **Liabilities are priced at the amounts expected to be paid to creditors. [This answer is correct. In liquidation, liabilities should be presented at the dollar amount that the company expects to pay the creditors.]**
- c. The discounted amount of cash to be paid is the presentation of the liabilities. [This answer is incorrect. When discounted the amount of the liabilities, they are valued at fair value. This should be an estimate of the current value of the liability.]
- d. The assets should be valued at an amount that could receive on the open market, based on the company not being compelled to sale. [This answer is incorrect. Valuing assets at a value that could be expected on the open market is an example of fair value basis of accounting.]

40. Which of the following would be considered a prescribed form? **(Page 216)**

- a. Tax return. [This answer is incorrect. Tax returns are not considered prescribed forms.]
- b. A preprinted form used to apply for a grant at a governmental agency. [This answer is correct. Prescribed forms include any standard preprinted form designed or adopted by the body to which it is to be submitted or filed. Examples include forms used by industry trade associations, credit agencies, banks and governmental and regulatory bodies.]**
- c. The comprehensive instructions not associated with a preprinted form. [This answer is incorrect. A comprehensive set of instructions not associated with a standard preprinted form does not constitute a prescribed form.]
- d. A reporting package designed by a parent company to collect information from its branches. [This answer is incorrect. Reporting packages designed by a company for use in gathering financial statements for subsidiaries, divisions or store locations is not considered a prescribed form.]

EXAMINATION FOR CPE CREDIT**Lesson 2 (OFSTG092)**

Determine the best answer for each question below. Then mark your answer choice on the **Examination for CPE Credit Answer Sheet** located in the back of this workbook or by logging onto the Online Grading System.

31. Which of the following is **not** an example of a regulatory basis of accounting?
- a. The accounting practice employed by a credit union with less than \$10 million in assets.
 - b. The basis used by a contractor bidding or working on government projects when submitting the state prequalification reports.
 - c. A partnership filing its financial statements with a bank to apply for a loan.
 - d. An insurance company that follows the rules of the state insurance commission.
32. Disclosure requirements for OCBOA are not as well defined as under GAAP. Which of the following is a disclosure requirement when producing OCBOA financial statements?
- a. If the financial statements are completed on a regulatory basis, then the disclosures only have to comply with regulatory requirements, not GAAP requirements.
 - b. If the financial statements are completed OCBOA, but contain items similar to GAAP, then the disclosures should also be similar to GAAP.
 - c. The basis of accounting must be made known to the user and the report does not have to explain its departures from GAAP.
 - d. All informative disclosures should follow GAAP, regardless of the basis of accounting.
33. Statutory accounting practices (SAP) are concerned with solvency. Financial statements that are presented in SAP are usually done on what basis?
- a. Liquidation.
 - b. Going-concern.
 - c. Fair Value.
 - d. Agreed-upon.
34. Which of the following is **not** an illustration of a permitted practice within the insurance industry?
- a. The insurance board in Minnesota requires all insurance agents to complete 12 hours of continuing education related to insurance regulations each year.
 - b. Sal is not allowed to write a homeowner's policy when there is a hurricane forming within a specified number of miles from land.
 - c. Martha files a homeowner's policy in accordance with the requirements of the insurance board of the State of Maryland.
 - d. The insurance board in Florida allows June to submit financial statements not completed on a regulatory basis in a year that the agency does not sell or maintain any insurance policies.

35. The liability for unpaid claims must be disclosed in the financial statements of insurance companies. One of those liabilities is claim adjustment expenses. Which of the following is an example of a claim adjustment expense?
- a. A claim that has been reported to the insurance company.
 - b. The cost of processing a claim.
 - c. An incurred claim, but one that has not been reported to the insurance company.
 - d. The payment of a current year insured event.
36. Which regulatory agency is required to file "call reports"?
- a. State agencies.
 - b. Insurance companies.
 - c. Banks and savings institutions.
 - d. Construction contractors bidding on governmental work.
37. Regulatory agencies have numerous SFAS to help them adhere to the guidelines. Which of the following SFASs offers guidance on accounting for intercompany profit, capitalizing costs and recording liabilities?
- a. SFAS No. 71.
 - b. SFAS No. 90.
 - c. SFAS No. 92.
 - d. SFAS No. 101.
38. When completing financial statements with the price-level basis of accounting, SFAS No. 89 provides accounting guidance for measuring the effects of changing prices on financial statement items. Which of the following should be stated in units of constant purchasing power?
- a. Foreign Currency.
 - b. Net Sales and Other Operating Revenues.
 - c. Inventory.
 - d. Property, Plant and Equipment.
39. What are the four categories of OCBOAs according to AU 623?
- a. Liquidation, fair value, historical and price-level.
 - b. Agreed-upon, cash, income tax and fair value.
 - c. Pure cash, modified cash, income tax and regulatory.
 - d. Regulatory, price-level, cash and liquidation.

40. If a company uses the liquidation basis of accounting when liquidation does not appear to be imminent, then the liquidation basis is considered an OCBOA.
- a. True.
 - b. False.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.

GLOSSARY

Adverse opinion. An *overall* audit opinion that states that the financial statements do *not* present fairly the financial position or the results of operations or cash flows in conformity with generally accepted accounting principles (GAAP) or an other comprehensive basis of accounting (OCBOA). Auditors must have as much sufficient evidential matter to support an adverse opinion as for an unqualified opinion.

Audit. Technically defined, auditing is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events, determining the degree to which those assertions correspond to established criteria, and communicating the results of the audit to interested users. For financial statements, an audit is an examination of accounting records and other supporting evidence for the purpose of expressing an opinion about whether or not the financial statements fairly represent the financial position, operating results, changes in owners' (stockholders') equity, and cash flows in accordance with GAAP or an OCBOA.

C corporation. A corporation organized under subchapter C of the Internal Revenue Code. A C corporation pays an income tax on taxable income at the entity level.

Compilation. Presenting, in the form of financial statements, information that is the representation of management (owners) without undertaking to express any assurance on the statements.

Consolidation. A reporting procedure in which the financial statements of the parent and the subsidiary are combined. The financial statements are prepared by the parent, not by the subsidiary. Consolidation is a reporting procedure only. It does not affect the accounting records of either the parent or the subsidiary.

Contingency. An event or condition that may occur in the future but that cannot currently be predicted. It has an uncertain outcome. The outcome of that event will change an existing condition or resolve a current uncertainty. A contingency is classified as probable (it is likely to happen), reasonably possible (it may happen, but the chance is neither likely nor remote), or remote (it is not apt to occur).

Disclaimer of opinion. An expression of *no* opinion. The auditor does not express an opinion on the financial statements due to lack of independence or pervasive and massive deficiency of evidence or uncertainty.

Disclosure. Description of pertinent facts in a financial report.

Financial statements. The principal means of communicating financial information to those users external to the entity. Financial statements are a formal tabulation of names and amounts of items derived from the accounting records by simplifying, condensing, and aggregating. They are a fundamentally related set of tabulations that articulate with each other and derive from the same underlying data. Financial statements are representations of the assertions of management. The fairness of their presentation in conformity with GAAP or an OCBOA is management's responsibility.

Generally accepted accounting principles (GAAP). Basic accounting principles and standards and specific conventions, rules, and regulations that define accepted accounting practice at a particular time by incorporation of consensus and substantial authoritative support. To prepare financial statements for *other than governmental entities* in accordance with GAAP, the CPA must apply those principles found in sources of established accounting principles as described in SAS 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.

Intangible assets. Nonphysical assets (lacking physical substance) whose value derives from the rights that their ownership confers (e.g., goodwill). The evidence of existence of an intangible asset is elusive, value is often difficult to estimate, and useful life is often indeterminable.

Limited liability company (LLC). A form of business organization created by statute which is a separate legal entity from its owners and has attributes of both a *corporation* and a *partnership*. A principal benefit of the LLC format is *limited liability* for its members and managers, so that such persons are not personally liable for the debts and obligations of the entity, similar to a *corporation*. Another principal benefit of the LLC format, when properly formed

and organized, is that the LLC does not incur tax liability at the entity level; it is a *pass-through entity*. The members of the LLC recognize the tax consequences, similar to a *partnership*.

Modified cash basis of accounting. The pure cash basis of accounting incorporating modifications of the cash basis having substantial support. Those modifications generally include the recognition of certain transactions on an accrual basis, as entities would recognize them under GAAP.

Other comprehensive basis of accounting (OCBOA). Financial records are maintained and reported according to a basis other than GAAP. A comprehensive basis of accounting other than GAAP is one of the following:

- A basis of accounting that the entity used to comply with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject (e.g., pursuant to the rules of a state insurance commission).
- A basis of accounting used to file income tax returns for the period covered by the financial statements.
- The cash receipts and disbursements basis of accounting, and modifications of the cash basis when such modifications are substantially supported, such as recording depreciation on fixed assets or accruing income taxes.
- A definite set of criteria having substantial support that is applied to all items appearing in financial statements, such as the price level basis of accounting.

Partnership. A form of business in which two or more persons join their money and skills in conducting the business as co-owners. Partnerships are treated as a conduit and are not subject to taxation. Various items of partnership income, expenses, gains, and losses flow through to the individual partners and are reported on their personal income tax returns.

Primary beneficiary. An enterprise that consolidates a variable interest entity under the provisions of FIN 46R.

Pure cash basis of accounting. Also known as the cash receipts and disbursements basis of accounting. Only transactions that increase or decrease cash and cash equivalents are reflected in the financial statement. Thus, the financial statement does not reflect noncash transactions. All disbursements of cash are recognized as cash decreases, and all receipts of cash are recognized as cash increases. Entities do not recognize transactions as they occur, but rather when they receive or disburse the cash.

Qualified opinion. This type of opinion states that except for the effects of the matter to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flow in conformity with GAAP or an OCBOA.

Related parties. SFAS 57 defines related parties as, among others, management, owners, family members of owners or management, affiliates, or any party that “can significantly influence the management or operating policies” such that the entity might be “prevented from fully pursuing its separate interests.” Related-party transactions must be fully disclosed in the notes to the financial statements, including the nature of the relationship involved, a description of the transaction, the dollar amounts of the transaction, and amounts due to and from related parties.

Review. An engagement undertaken to achieve, through the performance of inquiry and analytical procedures, limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with GAAP or, if applicable, with an OCBOA. The accountant on a review engagement must show due professional care and is required to be independent.

S corporation. A tax status election for corporations that meet the specified requirements under which they are taxed as a partnership (i.e., income passes through to the owners, who are then taxed on their share of the corporate earnings on their personal income tax returns). S corporations do not pay the corporate income tax, and corporate losses can be claimed by the shareholders, subject to the basis and passive loss rules. The requirements are located in subchapter S of the Internal Revenue Code (IRC).

Sole proprietorship. A business form of one person conducting business as an individual. It is not a legal, taxable entity separate from the owner. The owner is personally liable for the debts of the proprietorship. It is governed by the laws of contracts and agency. The owner may hire employees or agents (or independent contractors).

Statement of cash flows. One of the required financial statements. It replaced the statement of changes in financial position. Cash receipts and cash payments are classified into three categories:

1. Operating activities. All transactions and other events that are not investing or financing.

These generally include transactions that enter into the determination of net income—production and delivery of goods and services, interest and dividends received, and payment of interest.

2. Investing activities. All transactions related to the making or collecting of loans and the acquiring and disposing of debt, equity instruments, or property, plant, and equipment.
3. Financing activities. All transactions related to obtaining resources from owners and providing them with a return on, and a return of, their investment, and to obtaining and repaying debt.

Separate disclosure of noncash investing and financing activities is also required. Examples of such activities include obtaining an asset by entering into a capital lease, by exchange for another asset, or by the issuance of stock or debt.

Variable interest. A contractual, ownership, or other pecuniary interest whose fair value changes with changes in the fair value of the entity's net assets.

Variable interest entity. An entity is a variable interest entity if its equity is not sufficient or its equity investors do not have the characteristics of a controlling financial interest.

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2. ○	○	○	○	12. ○	○	○	○	22. ○	○	○	○	32. ○	○	○	○
3. ○	○	○	○	13. ○	○	○	○	23. ○	○	○	○	33. ○	○	○	○
4. ○	○	○	○	14. ○	○	○	○	24. ○	○	○	○	34. ○	○	○	○
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6. ○	○	○	○	16. ○	○	○	○	26. ○	○	○	○	36. ○	○	○	○
7. ○	○	○	○	17. ○	○	○	○	27. ○	○	○	○	37. ○	○	○	○
8. ○	○	○	○	18. ○	○	○	○	28. ○	○	○	○	38. ○	○	○	○
9. ○	○	○	○	19. ○	○	○	○	29. ○	○	○	○	39. ○	○	○	○
10. ○	○	○	○	20. ○	○	○	○	30. ○	○	○	○	40. ○	○	○	○

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- Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
- How many employees are in your company? _____
- May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. Yes/No ☐ ☐

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here _____

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Cash, Tax, and Other Bases of Accounting—Course 2— Income Tax Basis of Accounting and Other Bases of Accounting (OFSTG092)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

ONLINE GRADING. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

**Thomson Reuters
Tax & Accounting—R&G
OFSTG092 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700**

You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

Please allow a minimum of three weeks for grading.

Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.
3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of \$79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is \$225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is \$284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is \$336 (a 15% discount on all five courses or more).
4. To receive CPE credit, completed answer sheets must be postmarked by **September 30, 2010**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional \$24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.
5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.
6. Please direct any questions or comments to our Customer Service department at (800) 323-8724.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

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CPE Examination Questions (Lesson 1)	187
CPE Examination Questions (Lesson 2)	223

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Cash, Tax, and Other Bases of Accounting—Course 2—Income Tax Basis of Accounting and Other Bases of Accounting (OFSTG092)

Price \$79

First Name: _____

Last Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State /ZIP: _____

Firm Phone: _____

Firm Fax No.: _____

Firm Email: _____

Express Grading Requested: ☐ Add \$24.95

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ○ ☒ ☐ ☐ ☐ .

a	b	c	d	a	b	c	d	a	b	c	d	a	b	c	d
1. ○	○	○	○	11. ○	○	○	○	21. ○	○	○	○	31. ○	○	○	○
2. ○	○	○	○	12. ○	○	○	○	22. ○	○	○	○	32. ○	○	○	○
3. ○	○	○	○	13. ○	○	○	○	23. ○	○	○	○	33. ○	○	○	○
4. ○	○	○	○	14. ○	○	○	○	24. ○	○	○	○	34. ○	○	○	○
5. ○	○	○	○	15. ○	○	○	○	25. ○	○	○	○	35. ○	○	○	○
6. ○	○	○	○	16. ○	○	○	○	26. ○	○	○	○	36. ○	○	○	○
7. ○	○	○	○	17. ○	○	○	○	27. ○	○	○	○	37. ○	○	○	○
8. ○	○	○	○	18. ○	○	○	○	28. ○	○	○	○	38. ○	○	○	○
9. ○	○	○	○	19. ○	○	○	○	29. ○	○	○	○	39. ○	○	○	○
10. ○	○	○	○	20. ○	○	○	○	30. ○	○	○	○	40. ○	○	○	○

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: September 30, 2010

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to Cash, Tax, and Other Bases of Accounting—Course 2— Course Acronym: OFSTG092
Income Tax Basis of Accounting and Other Bases of Accounting

Your Name (optional): _____ Date: _____

Email: _____

Please indicate your answers by filling in the appropriate circle as shown:

Fill in like this ☒ not like this ☐ ☐ ☒.

Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
2. How would you rate the examination related to the course material?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
3. Does the examination consist of clear and unambiguous questions and statements?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
4. Were the stated learning objectives met?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
5. Were the course materials accurate and useful?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
7. Was the time allotted to the learning activity appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
8. If applicable, was the technological equipment appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
10. If applicable, how well did the audio/visuals contribute to the program?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.

(Please print legibly):

Additional Comments:

- What did you find **most** helpful? _____
- What did you find **least** helpful? _____
- What other courses or subject areas would you like for us to offer? _____
- Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
- How many employees are in your company? _____
- May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes/No** ☐ ☐

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