PacificCPE

COURSE

20455A

Navigating Practical Engagement Challenges

Building on earlier practice issues content, this course continues exploring the real-world complexities that CPAs encounter during compilation and review engagements. Through continued observations and applied examples, practitioners gain deeper insight into how to handle situations that don't fit neatly into the standards. This course is well-suited for accountants who want to strengthen their judgment and decision-making skills when working through nuanced or nonroutine engagement scenarios.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 10

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Final Exam Copy ↓

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

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Section 1

Assignment 1 Objectives

After completing this chapter, you should be able to:

- Identify an example of a deferred M-1 that is eliminated by tax-basis financial statements.
- Recognize some of the general rules for tax-basis financial statements.
- Identify the options available to report on supplementary information in a *compilation or* review engagement.

J. USING TAX-BASIS FINANCIAL STATEMENTS FOR ENGAGEMENT PROFITABILITY

General

As CPAs seek ways to reduce overall engagement time for compilation and review engagements, they seem to overlook using tax-basis[1] financial statements. The author observes that few CPAs use tax basis for engagements beyond limited disclosure compilation engagements. That is, most engagements related to nonpublic entities (e.g., full disclosure compilations, reviews, and even audits) continue to be performed using traditional GAAP as the framework.

Major differences can exist between GAAP and taxable income due to the upheaval of the tax code starting in the 1980s through the current *period.* Thus, nonpublic entities find a continued conflict between balancing a desired lower taxable income for tax planning with higher financial statement income necessary to appease the bank or third party investor. In certain cases, tax-basis financial statements act to bridge this gap so that tax-basis and GAAP financial statements are more aligned. This is particularly true with respect to a traditional nonpublic manufacturer, retailer or wholesaler who may be a perfect candidate for income tax-basis accrual financial statements. With respect to cash-basis financial statements, many smaller businesses, in particular professional practices, can easily use cash or hybrid-basis financial statements instead of a costlier accrual basis GAAP format. Let's not forget that the accountant can benefit from use of tax-basis financial statements if the time saved can be used to either reduce the billing to the client or be retained by the accountant to make the engagement more profitable.

Prior to the issuance of SSARS No. 21, the term "other comprehensive basis of accounting" (OCBOA) was used to describe non-GAAP financial reporting frameworks, such as income tax basis, cash basis, regulatory, and contractual basis of accounting.

SSARS No. 21 introduces a new definition of non-GAAP financial reporting frameworks, referred to as a "special purpose framework," which is carried over from the auditing standards that were revised in SAS Nos. 122-124.

SSARS No. 21 defined a special purpose framework as any one of the following bases of accounting:

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

Although the term "other comprehensive basis of accounting" (OCBOA) is no longer used in the formal sense, in practice it's use is still common to refer to non-GAAP bases of accounting.

For most situations, tax-basis financial statements are the most meaningful as follows:

1. Tax basis is usually based on the Federal income tax laws and regulations found in the Internal Revenue Code (IRC), although other tax codes can be used, such as state or local taxation.
2. Accrual basis is the most meaningful form of tax-basis financial statements, although financial statements using the cash, modified cash, or any other method that clearly reflects income under Section 446 of the IRC may be used.

Observation

One of the advantages of tax-basis financial statements is that there are few accounting issues that need to be addressed. Essentially, all transactions are accounted for in accordance with the Internal Revenue Code or another code of taxation. Of course, there may be instances where the tax treatment of an item is at issue.

When to Use Tax-Basis Financial Statements

In determining whether tax-basis financial statements are appropriate for a client, major factors that should be considered include who the users of the financial statements will be and whether

there are any contractual agreements or regulatory requirements that prohibit issuance of non-GAAP financial statements.

Generally, tax-basis financial statements are best used and most useful in the following situations:

1. There is a less financially sophisticated, nonpublic client who is:
   a) Tax motivated and interested in cash flows, and
   b) Actively involved in the day-to-day operations.
2. The company is in a strong financial position and will not be forced into debt covenant violations by presenting a lower taxable income.
3. There is incentive to reduce overall engagement time.
4. The accountant is motivated to reduce overall engagement time either through pressure from the client or to improve the profitability of the engagement.

Observation

The author suggests that an accountant should seriously consider the time savings in convincing his or her client to use tax-basis financial statements. Based on experience, the author estimates an overall engagement time savings of 10% for compilations, 15-18% for reviews, and 15-25% for audits. For fixed-fee engagements, any savings will usually inure to the benefit of the accounting *firm.* Moreover, most third parties, particularly banks, will accept tax-basis financial statements for compilation and review engagements, albeit less so for audited financial statements. If loan documents do not refer to GAAP in the description of the financial statements to be issued at year-end, the author believes that the accountant may report on tax-basis financial statements as a matter of right.

When Not to Use Tax-Basis Financial Statements

It may be prudent not to use tax-basis financial statements if the statements may be perceived to be intentionally misleading by a third party or may violate loan covenants. Examples of situations in which a third party may perceive the use of tax basis to be intentionally misleading include:

1. Having a large number of uncollectible receivables for which the tax basis would not provide an allowance for doubtful accounts.
2. Having a large contingency for environmental liabilities and litigation for which an accrual would not be recorded using the tax basis.
3. A situation in which a contract or loan agreement explicitly states that GAAP financial statements must be issued to comply with that agreement.

Accountants, in fact, should deal with the third situation identified above; that is, when a loan agreement requires that GAAP statements be issued. Without a waiver from that lender, it is difficult

for an accountant to report on tax-basis financial statements knowing that the issuance and submission of those statements violates the loan agreement. A better choice is for the accountant or a client to seek a waiver from the lender to issue tax-basis financial statements.

SSARS No. 21 Requirement to Ensure Tax Basis Is "Acceptable"

SSARS No. 21 adds a new requirement under which the accountant must determine that any non-GAAP framework, such as tax basis, is "acceptable" as a condition to performing the SSARS engagement.

Paragraph .26 of AR-C 60 states that a condition for an accountant accepting a SSARS engagement is that the accountant must:

1. Determine whether the financial reporting framework selected by management to be applied in the preparation of the financial statements is acceptable, and
2. Make reference in the compilation or review report to management's responsibility for determining that the tax basis framework is acceptable in the circumstances when management has a choice of financial reporting frameworks in the preparation of such financial statements.

Factors that SSARS No. 21 states are relevant to the accountant's determination that the tax-basis framework selected by management is acceptable include the following:

- Consideration of the nature of the entity
- The intended purpose of the financial statements, and
- The users of the financial statements.

Examples:

- Whether they are prepared to meet the common financial information needs of a wide range of users, and
- Whether law or regulation prescribes the applicable financial reporting framework.

The key factor that should be considered in determining whether tax-basis financial statements would be "acceptable" is whether the users of the financial statements (such as a bank) will accept them and find the tax-basis framework to be useful.

Tax-Basis Accrual Financial Statements- Differences from GAAP

When using tax-basis financial statements prepared under the Internal Revenue Code, there are clear differences between GAAP and taxable income. In particular, in tax-basis financial statements, all deferred M-1 items are eliminated while permanent, flow-through M-1 items are retained. Deferred M-1 items are all M-1 items that reverse and, on which, deferred income taxes are

computed. Conversely, permanent M-1 items consist of all M-1s that do not reverse, such as meal and entertainment and key- man life insurance. A listing of these items follows:

1. All deferred M-1 items are eliminated:
    - Depreciation- MACRS depreciation is used for tax-basis financial statements, including the Section 179 and bonus depreciation.
    - UNICAP difference- IRC Section 263A adjustment under the uniform capitalization rules, is capitalized to tax-basis financial statement inventory.
    - No unrealized gains or losses on securities- securities are recorded at cost and not recorded at fair value per GAAP.
    - No related-party or vacation-pay accruals- all related-party and vacation-pay accruals are recorded on a cash basis.
    - Amortization follows the 15-year tax life- most intangibles, including goodwill, are amortized over their tax life of 15 years.
    - No allowance for bad debts- the direct write-off method is used.
    - No impairment of assets- assets are recorded at cost with no measurement or consideration of asset impairments.
    - No goodwill impairment- goodwill is amortized over the 15-year tax life and no impairment losses are recorded.
2. All permanent differences are retained within tax-basis financial statements, such as:
    - Meals and entertainment
    - Key-man life insurance
    - Dividend exclusion
    - Penalties and fines, and
    - Non-taxable interest income.
3. Deferred income taxes are eliminated.
4. No statement of cash flows is required per ASC 230.[2]
5. Tax-basis financial statements can be perfect for non-profits that wish to avoid the requirements of ASC 958, such as:
    - Donated services are not recorded
    - Statement of cash flows is not required, and
    - Statement of functional expenses and the presentation of the amount of unrestricted, temporarily restricted and permanently restricted net assets are not required.
6. GAAP consolidation rules do not apply:
    - Consolidation of variable interest entities is not applicable.

Note

ASC 810 is not applicable, so there is no risk that a rental entity would have to be consolidated with its related party operating entity lessee.

Consolidation is based on the IRC threshold of 80% ownership for tax-basis financial statements.

The Four Disclosures Required for Tax-Basis Financial Statements

If special purpose framework financial statements are issued, those financial statements must include four disclosures related to the special purpose framework as follows:

1. A description of the special purpose framework in the financial statement titles, notes, or on the face of the financial statements
2. A summary of significant accounting policies
3. Basis of accounting: an adequate description about how the special purpose framework differs from GAAP. The effects of these differences need not be quantified, and
4. Informative disclosures similar to those required by GAAP when the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP.

If, however, management elects to omit substantially all disclosures, and such an omission is not undertaken with the intention to mislead potential users of such financial statements, the above presented four disclosures are not required.

Disclosure 1: Description of the special purpose framework (tax basis)

The first disclosure for tax-basis financial statements required by SSARS No. 21 is that financial statements prepared on a special purpose framework (such as tax basis) must provide a description of the special purpose framework unless the entity elects to omit substantially all disclosures.

1. The SSARS states that the description may be included:
    - In the financial statement titles
    - In the notes to the financial statements, or
    - On the face of the financial statements.

SSARS No. 21 clarifies that traditional GAAP titles, such as balance sheet, statement of financial position, statement of income, etc., may be used for special purpose framework financial statements, provided such titles are "appropriately modified."

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

Modified cash basis:

Income Statement- Modified Cash Basis

Statement of Income- Modified Cash Basis**

Statement of Cash Receipts and Disbursements

Tax-basis of accounting:

Balance Sheet- Tax Basis

Statement of Assets, Liabilities, and Equity- Tax Basis

Statement of Operations- Tax Basis

Statement of Revenue and Expenses- Tax Basis

Statement of Income- Tax Basis**

Regulatory basis:

Statement of Income- Regulatory Basis

Balance Sheet- Regulatory Basis

** Added to list by author.