PacificCPE

COURSE
20901A

Introduction to Tax-Basis Financial Statements

Get oriented with the structure and scope of tax-basis financial statements in this introductory course. You'll review the course layout, learning assignments, and key objectives that guide the full curriculum. Ideal for CPAs and tax professionals who prepare or review financial statements using the tax basis of accounting, this starting point sets the foundation for understanding how tax-basis reporting differs from GAAP and when it's the right choice for your clients.

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

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LEARNING ASSIGNMENTS AND OBJECTIVES

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.

Course Objectives

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

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Publication Date: April 2026

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TAX-BASIS FINANCIAL STATEMENTS

Chapter Objective

After completing this course, you should be able to:

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

A. OVERVIEW

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

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

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

B. PRESENT REPORTING AND DISCLOSURE AUTHORITY- TAX BASIS

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

> SAS No. 139, AU-C Section 800, *Special Considerations- Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*[2]
>
> SSARS No. 21, *Statements on Standards for Accounting and Review Services: Clarification and Recodification*

Even though two sets of standards provide the overall authority for using tax-basis financial statements, there is little guidance that addresses the practical application of tax-basis financial

statements, including overall financial statement format, specific disclosures that are required, and other matters such as how to handle certain permanent M-1 items.

C. REVISED DEFINITION OF TAX-BASIS FINANCIAL STATEMENTS

Question: What is the revised definition of tax basis?

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

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

> **Cash basis:** A basis of accounting that the entity uses to record cash receipts and disbursements and modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets).
>
> **Tax basis:** A basis of accounting that the entity uses to file its income tax return for the period covered by the financial statements. Tax basis can include cash basis, accrual basis, or any method that clearly reflects income under Section 446 of the Internal Revenue Code.
>
> **Regulatory basis:** A basis of accounting that the entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject (for example, a basis of accounting that insurance companies use pursuant to the accounting practices prescribed or permitted by a state insurance commission.)
>
> **Contractual basis:** A basis of accounting that the entity uses to comply with an agreement between the entity and one or more third parties other than the auditor.
>
> **Other basis:** A basis of accounting that uses a definite set of logical, reasonable criteria that is applied to all material items appearing in financial statements.

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

Observation

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

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

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

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

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

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

When to use tax-basis financial statements:

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

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

When not to use tax-basis financial statements:

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

a. They should not be considered where the financial statements may be misleading.

The author believes there are two specific situations in which the use of tax-basis financial statements could be considered misleading.

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

Note

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

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

Note

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

E. DEFERRED M-1S ARE ELIMINATED WITH TAX-BASIS FINANCIAL STATEMENTS

Question: How should deferred M-1 items be handled in tax-basis financial statements?

Response: With tax-basis financial statements, all deferred M-1 items are eliminated but permanent M-1s are still presented in tax-basis financial statements. That is, deferred M-1 items do not exist because they follow the Internal Revenue Code.

a. Deferred M-1 items are book-tax income and expense differences that ultimately reverse.

Note

Under GAAP, deferred M-1s are called "timing differences." The cumulative deferred M-1s are considered temporary differences, which are the book-tax basis differences in assets and liabilities, such as accumulated depreciation.

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

Deferred M-1s Eliminated (Federal Tax Basis):

- One depreciation method
- No UNICAP difference

- No unrealized gains on securities- ASC 320
- No related party accruals
- No vacation accruals
- No allowance for bad debts
- No impairment of assets issues
- No deferred income taxes
- No impairment of goodwill or amortization difference

- No consolidation of variable interest entities

F. NONTAXABLE REVENUE AND NONDEDUCTIBLE EXPENSES- PERMANENT DIFFERENCES

Question: How should permanent M-1 items be accounted for in tax-basis financial statements?

Response: Permanent differences (permanent M-1s) consist of nontaxable revenues and nondeductible expenses that do not reverse in future years. They are more commonly referred to as flow-through items.

Permanent differences are included on the tax-basis financial statements as income and expense items, even though such items are not included as part of taxable income on the tax return.

Examples of permanent differences follow:

- Meals expense [3]
- 100% of entertainment expense [4]
- Key-man life insurance expense
- Dividend income exclusion
- Penalties and fines expense
- Non-taxable interest income
- Non-taxable cancellation (forgiveness) of debt income

There is no authoritative guidance that addresses how to present permanent differences in the tax-basis financial statements.

The author suggests three ways to present these permanent differences:

- As income and expense items scattered in the tax-basis income statement
- As separate items in the income statement in the other income and expense section
- As adjustments through retained earnings

The most common method in practice is to present the permanent differences on the tax-basis income statement and not necessarily in retained earnings.

Example: Company X has two permanent differences:

Permanent differences:	
Key-man life insurance expense	(2,000)
Non-taxable interest income- municipal bonds	3,000

Conclusion: One way to present the permanent differences is to present them separately on the income statement.

Company X

Statement of Income- Tax Basis

For the Year Ended December 31, 20X1

Net sales	$XX
Cost of sales	XX
Gross profit	XX
Operating expenses	XX
Net operating income	XX
Other income (expense):	
Key-man life insurance expense	(2,000)
Non-taxable interest income	3,000
Net income before income taxes	XX
Income taxes- federal	XX
Net income	$XX

G. CONVERTING TO TAX-BASIS FINANCIAL STATEMENTS

Question: How should an entity account for the conversion to tax-basis financial statements?

Response: A change to tax-basis financial statements does not represent a change in accounting principle in accordance with ASC 250, *Accounting Changes and Error Corrections*.

Therefore, there is no requirement to justify the change.

There is no authoritative guidance as to how an entity should account for the change from GAAP to the tax-basis of accounting.