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Accounting and financial reporting guidelines for cash- and tax-basis financial statements

American Institute of Certified Public Accountants (AICPA)

PRACTICE AID SERIES

Accounting and Financial Reporting Guidelines For Cash- and Tax-Basis Financial Statements

AICPA®

P R A C T I C E A I D S E R I E S

Accounting and Financial Reporting Guidelines For Cash- and Tax-Basis Financial Statements

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Preface

Because of the complexities of accounting principles generally accepted in the United States of America (GAAP), many smaller entities have determined that financial statements prepared by applying the cash- or tax-basis of accounting more appropriately suit their needs. Unlike GAAP, little authoritative guidance is available with respect to the preparation of financial statements when applying the cash- or tax-basis of accounting. Financial statements prepared when applying the cash- or tax-basis of accounting need to have a level of consistency so that they are useful and not misleading to users of the financial statements. Additionally, because financial statements prepared when applying the cash- or tax-basis of accounting are not considered appropriate in form unless the financial statements include informative disclosures similar to those required by GAAP if the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, preparers of full disclosure financial statements prepared when applying the cash- or tax-basis of accounting are often faced with difficult questions.

This practice aid is intended to provide preparers of cash- and tax-basis financial statements with guidelines and best practices to promote consistency and for resolving the often difficult questions regarding the preparation of such financial statements. Although this practice aid is the best source for such guidance, it is nonauthoritative and should not be used as a substitute for the preparer's professional judgment. This practice aid has not been approved, disapproved, or otherwise acted upon by any senior committee of the AICPA.

This practice aid does not contain guidance with respect to auditing, reviewing, or compiling financial statements prepared when applying the cash- or tax-basis of accounting. Practitioners engaged to audit such financial statements should refer to Statements on Auditing Standards, including AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*). Practitioners engaged to review or compile such financial statements should refer to Statements on Standards for Accounting and Review Services.

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Acknowledgments

In 1998, the AICPA published the Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements*. That publication was written by Michael J. Ramos, CPA, and edited by the AICPA Accounting and Publications Team. That publication served as a basis for the preparation of this practice aid.

In addition to this practice aid, the AICPA has also published a separate practice aid, *Applying OCBOA in State and Local Government Financial Statements*, authored by Michael A. (Mike) Crawford, CPA. Mike served as an invaluable resource in the preparation of this practice aid.

The AICPA also greatly appreciates the invaluable input provided by Thomas A. Ratcliffe in the development of this practice aid.

Finally, the AICPA would like to thank the 2011/12 members of the Accounting and Review Services Committee and the 2011/12 members of the AICPA PCPS Technical Issues Committee, who provided invaluable input regarding the content of this practice aid.

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Chapter 1

Overview of Cash- and Tax-Basis Financial Statements

Introduction

Financial statements, including related notes, are a structured representation of historical financial information intended to communicate an entity's economic resources and obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework.[1] All financial statements are prepared in accordance with a financial reporting framework. The term *financial reporting framework* is defined as "a set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements."[2] Examples of financial reporting frameworks are accounting principles generally accepted in the United States of America (GAAP), International Financial Reporting Standards, and other comprehensive bases of accounting (OCBOA). The cash-basis (including modifications of the cash-basis having substantial support) and the tax-basis are two examples of OCBOA frameworks.[3]

As GAAP becomes increasingly complex and less cost beneficial for private companies, such companies consider issuing cash- and tax-basis financial statements as cost-effective and useful alternatives. Many of these private companies are small and medium-sized entities that report to a narrow range of financial statement users. Those users, unlike users of public company financial statements, typically have access to company management and additional financial information beyond that provided in the financial statements.

Cash- or tax-basis financial statements may be appropriate whenever the entity is not contractually or otherwise required to issue GAAP financial statements. The following conditions may indicate that financial statements prepared when applying the cash- or tax-basis of accounting is appropriate:

1. Paragraph .04 of AR section 60, *Framework for Performing and Reporting on Compilation and Review Engagements* (AICPA, *Professional Standards*), and paragraph .13 of AU-C section 200, *Overall Objectives of the Independent Auditor and Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*).

2. See footnote 1.

3. The cash and tax bases of accounting are also defined as *special purpose frameworks* in paragraph .07 of AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*).

- The users of the financial statements—both internal and external to the entity—understand a cash- or tax-basis presentation and find it relevant for their needs.
- It is cost-effective to prepare cash- or tax-basis financial statements.
- The operations of the entity are conducive to a cash- or tax-basis presentation.

Preparing cash- or tax-basis financial statements has many benefits. A significant benefit is due to the fact that many smaller entities maintain their accounting records on a cash- or tax-basis. Often, accounting and finance personnel responsible for maintaining the books and records can more easily understand the concepts of cash in and out as well as tax reporting compared to GAAP. Because the internal records are often maintained on the cash- or tax-basis of accounting, it is easier to prepare the financial statements when applying that same basis. If the financial statements are prepared in accordance with GAAP, the accounting and finance personnel would "true-up" the financial information through a series of journal entries. Additionally, many users of smaller entity financial statements find cash- or tax-basis financial statements to be more understandable than financial statements prepared in accordance with GAAP because those users are often accustomed to preparing and considering budgets on a cash-basis and understand tax issues.

Because many smaller entities are appropriately concerned with minimizing costs and maximizing the resources that are available to fund the operations of the business, resources allocated to accounting and financial reporting are often not sufficient to maintain GAAP basis accounting records and to prepare financial statements in accordance with GAAP. Preparing financial statements when applying the cash- or tax-basis of accounting generally is less costly than preparing GAAP financial statements because of the following:

- *Less complex measurement requirements.* Financial statements prepared when applying the cash-basis of accounting reflect transactions resulting from cash receipt and disbursement transactions or events. Financial statements prepared when applying the tax-basis of accounting reflect transactions in the same manner as those transactions are reflected in the entity's tax return.
- *Less extensive disclosure requirements.* Financial statements prepared when applying the cash- or tax-basis of accounting do not require all of the extensive disclosures required of GAAP statements because the statements do not include some of the items, events, and transactions that are typically included in GAAP basis financial statements.

Practice Tip

Often, preparers of cash- and tax-basis financial statements elect to omit substantially all disclosures required by the cash- or tax-basis of accounting. The omission of disclosures is a departure from the cash- or tax-basis of accounting and, if such disclosures were included in the financial statements, they might influence the user's conclusions about the entity's financial position, results of operations, and cash flows. However, the omission may not necessarily result in misleading financial statements provided that the intended users are informed about such matters.

- *Ability to prepare tax returns and financial statements from the same information.* When tax-basis financial statements are issued, a significant portion of the cost can be absorbed by the preparation of the tax return. Additionally, the entity is not required to maintain two sets of accounting records to account for items such as depreciation, bad debts, and consolidation matters.

However, in addition to the benefits of financial statements prepared when applying a cash- or tax-basis of accounting, financial statement preparers should also be aware of the limitations of such financial statements. For example, financial statements prepared when applying the cash- or tax-basis of accounting may not meet the needs of certain users such as regulators and certain lenders. In addition, the cash-basis of accounting can be easily manipulated by accelerating or delaying the timing of the receipt or disbursement of cash and therefore may not be a comprehensive measure of the entity's complete economic condition.

In practice, the most typical industries in which cash- or tax-basis financial statements are issued include the following:

- Professional services
- Medical
- Retail
- Real estate
- Farming/agricultural
- Construction
- Not-for-profit

Cash-Basis of Accounting

The cash-basis of accounting is a basis of accounting that the entity uses to record cash receipts and disbursements. When applying the cash-basis of accounting, transactions are recognized based on the timing of cash receipts and disbursements. As a result,

- revenues are recognized only when cash is received rather than when earned, and
- expenses are recognized only when cash is paid rather than when the obligation is incurred.

When applying the cash-basis, cash outflows to purchase an "asset" are not capitalized but instead are recorded as a disbursement as of the date of purchase, so there is no depreciation or amortization. Accruals are not made and prepaid assets are not recorded.

The cash-basis of accounting in its purest form is rarely used but may be appropriate whenever the entity

- is interested primarily in sources and uses of cash.
- has a limited number of financial statement users.
- has relatively simple operations engaged in one primary activity.
- does not have significant amounts of debt, capital assets, or other items that would be recognized in accordance with the accrual basis.

Examples of some entities that may use the cash-basis of accounting include the following:

- Estates
- Trusts
- Civic ventures
- Student activity funds
- Political campaigns and committees

When applying the cash-basis of accounting, because the only assets of the entity would be cash and cash equivalents and there would be no liabilities, a balance sheet equivalent is often not presented. The income statement equivalent would report cash receipts and disbursements and other changes in cash and cash equivalents and disclose any restrictions on ending cash and cash equivalents.

Any departure from the presentation of cash and cash equivalent balances and changes in such balances, such as the reporting of long-term debt arising from cash transactions, the capitalization and depreciation of capital assets acquired with cash, or the reporting of investments or receivables and payables resulting from cash transactions, should be considered a modification to the cash-basis of accounting. Such deviations require evaluation regarding whether they are appropriate modifications of the cash-basis of accounting. Appropriate modifications of the cash-basis of accounting are discussed in the subsequent section.

In-Substance Two-Step Transactions or Events in the Cash-Basis of Accounting

The preparer of cash-basis financial statements may encounter single-step transactions or events that may not directly involve a cash inflow or outflow but may nevertheless be recorded as an in-substance two-step cash transaction or event when applying the cash-basis of accounting. For example, management of an entity may sign a note from a bank in order to purchase equipment. The bank may then directly pay the vendor for the purchase of the equipment. Because there was no cash transaction, the entity may not record the single-step transaction in the financial statements. However, so as not to be misleading to users of the financial statements, the preparer may choose to record the transaction as an in-substance two-step transaction. In accordance with that treatment, the journal entries may look as follows:

Cash	XX,XXX
Note Proceeds (Revenue)	XX,XXX
(To record note proceeds that were paid directly to the vendor)	
Capital expenditure	XX,XXX
Cash	XX,XXX
(To record purchase of equipment)	
Then, subsequent payments on the note would be recorded as follows:	
Debt service expenditure	XXX
Cash	XXX
(To record principal and interest payment on note payable)	

Modified Cash-Basis of Accounting

The modified cash-basis of accounting involves logical and consistent modifications to transactions or events that are derived from cash receipts or cash disbursements. For example, a modification to the cash-basis of accounting to report capital assets should involve recording and depreciating only those capital assets that result from cash transactions or events. The modification should not involve the recording and depreciating of donated capital assets because these transactions or events do not involve an inflow or outflow of cash. Once depreciable capital assets arising from cash transactions or events are recorded when applying a modified cash-basis of accounting, such assets should also be depreciated over their estimated useful lives. Depreciating capital assets that were acquired with cash is a logical allocation of the cash-basis assets' costs over the assets' useful lives.

An easy way to look at whether a modification is appropriate is to consider whether the transaction or event would have been recorded if the entity was preparing the cash-basis financial statements. For example, if an entity purchased a capital asset and was preparing cash-basis financial statements, the journal entry would look like this:

Capital expenditure	XXXX
Cash	XXXX
(To record purchase of capital asset)	

Because cash is part of the journal entry, it would be an appropriate modification to capitalize the asset and depreciate the cost over the estimated useful life of the asset.

On the other hand, the recording of trade accounts receivable arising from services provided or goods sold would not be an appropriate modification of the cash-basis of accounting assuming cash was not received at the time the services were provided or goods were sold.

Modifications to the cash-basis of accounting generally result when cash receipts or cash disbursements provide a benefit or an obligation that covers multiple reporting periods. For example, a preparer may conclude that financial statement users would be misled if cash purchases of capital assets are recorded as disbursements or expenditures in the period in which the assets are purchased. Instead, the preparer may elect to modify the cash-basis of accounting to record the asset on the balance sheet equivalent and depreciate it over the estimated useful life of the asset, thereby, in effect, spreading the benefit of the cash outflow over multiple reporting periods in a manner that has substantial support and is logical and consistent.

Questions often arise in the application of a modified cash-basis of accounting regarding whether reported assets and liabilities derived from cash transactions or events should ever be written down or written off once they are recorded at their original cash value. Temporary changes in the fair value of an asset or liability should not be recognized in applying a modified cash-basis of accounting and all recognized assets and liabilities should be measured and reported at their original cash value (net of any accumulated depreciation or amortization, if applicable). If an asset or liability has been permanently impaired and has no future cash value or represents no future obligation against cash, it would be appropriate to write-down or write-off such amounts in modified cash-basis financial statements.

A significant challenge to preparing financial statements when applying a modified cash-basis of accounting is developing the appropriate accounting policy that results in financial statements that meet the needs of the primary users of the statements and consistently applying that policy to cash transactions and events in order to keep the financial statements from being misleading for the purposes for which they are intended. The preparer may find benefit in spelling out the logic behind the cash-basis modifications and documenting the accounting policy prior to preparation of the basic financial statements.

Although there is no single accepted method of applying a modified cash-basis of accounting, modified cash-basis financial statements can be more meaningful if they are comparable with similar financial statements. Some preparers have inappropriately considered the modified cash-basis of accounting as a "free-for-all" proposition in which they can unilaterally and arbitrarily choose the modifications that they will apply. For example, a preparer may inappropriately decide to prepare financial statements applying a modified cash-basis of accounting that records assets arising from cash transactions or events, including investments, inventories, and capital assets but does not record short-term and long-term liabilities and other obligations arising from cash transactions. Inconsistent uses of a modified cash-basis framework should be avoided in general use financial statements because such inconsistencies will normally result in financial statements that are misleading for general use. Financial statements that are prepared using inconsistent modifications may be appropriate for special purposes involving limited users but should be labeled as such with clear disclosure and use of descriptive headings.

With the needs of the primary financial statement users in mind, when preparing financial statements applying a modified cash-basis of accounting, the preparer should consider modifying the following cash transactions or events, among others, by the recording of the following:

- Receivables resulting from an outflow of cash, such as a cash advance to an employee
- Investments in marketable securities acquired with cash
- Inventories acquired with cash
- Capital assets arising from cash transactions and depreciating the assets where appropriate
- Deferred revenue resulting from cash receipts

- Liabilities resulting from short-term cash borrowings
- Long-term notes and other debt arising from cash transactions or events
- Any other material assets, liabilities, revenues, and expenses resulting from cash transactions or events

If the financial statements are prepared when applying a modified cash-basis accounting policy in which one or more of the preceding—but not all—are recorded, the preparer should be prepared to defend how the decision to modify or not modify is a logical and consistent application of the accounting policy and does not result in misleading financial statements for the purposes for which they are intended.

A number of transactions or events are not appropriate modifications to the cash-basis of accounting. Generally, these transactions or events should not be recorded when applying a modified cash-basis of accounting because they do not involve cash inflows or outflows, are illogical, or are not substantially supported in the accounting literature. Common transactions or events that should not be reported in financial statements prepared when applying a modified cash-basis of accounting include the recording or adjusting of the following:

- Capital assets arising from cash transactions or events, but not recording depreciation where appropriate
- Donated capital assets where cash outflows were not involved
- Accounts receivable from services provided or goods sold and other accrued receivables
- Pledges receivable or other receivables where cash outflows were not involved
- Investments for which cash outflows were not involved
- Accounts payable for goods or services received where no cash outflow was involved
- Accrued income taxes, accrued interest expense, other accrued liabilities where no cash outflow was involved
- Subsequent write ups or write downs to fair value to recognize unrealized gains and losses on marketable investments
- Derivative instruments where cash inflows or outflows were not involved as well as the mark to market for fair value changes

Because modified cash-basis frameworks do not involve financial statement elements resulting from accruals and noncash transactions or events, it is unlikely that an acceptable modified cash-basis framework would ever be materially equivalent to GAAP. However, it is important for financial statements preparers to avoid attempting to make certain modifications to GAAP financial statements and then referring to those financial statements as modified cash-basis financial statements. For example, financial statements that are presented in conformity with GAAP, except that material leases are not capitalized, are not considered modified cash-basis financial statements. Such financial statements are considered GAAP financial statements with a material departure due to the failure to capitalize material leases. The preparer will need to use judgment in determining if modified "cash-basis" statements are tantamount to financial statements purported to be prepared in accordance with GAAP with material departures therefrom.

Tax-Basis of Accounting

The tax-basis is a basis of accounting that the entity uses to file its federal income tax or federal information return for the period covered by the financial statements.

The tax-basis of accounting is based on the principles and rules for accounting for transactions under the federal income tax laws and regulations. Few new measurement guidelines need to be established because the method is based on tax laws. The tax-basis of accounting covers a range of alternative bases, from cash to full accrual, depending on the nature of the taxpayer, and in some circumstances, the taxpayer's elections.

An entity need not be a taxable entity to prepare tax-basis financial statements. Any entity that files a return with the IRS, either an income tax return or an information return, may prepare tax-basis financial statements. Therefore, not-for-profit organizations, C corporations, S corporations, partnerships, limited liability partnerships, limited liability companies, and sole proprietors may all use the tax-basis of accounting.

The tax-basis of accounting is most useful for small, nonpublic entities whose financial statement users are interested primarily in the tax aspects of their relationship with the entity. For example, investors in tax-driven partnerships, such as those commonly employed in the real estate industry, may be primarily interested in the tax consequences of transactions. However, they may want more information than would be provided by a tax return.

Determining Whether to Prepare and Issue Cash- or Tax-Basis Financial Statements

As long as the entity is not contractually or otherwise required to issue financial statements prepared in accordance with GAAP or a regulatory or contractual basis of accounting, the entity may prepare and issue cash- or tax-basis financial statements. Understanding the needs of the financial statement users is an important step in determining whether to prepare and issue cash- or tax-basis financial statements. If the users of the financial statements understand the presentation, and if the information presented when applying that basis of accounting is relevant to their needs, then the preparer may determine that it is useful and appropriate to prepare and issue cash- or tax-basis financial statements. The following are characteristics of entities that generally are good candidates to prepare cash- or tax-basis financial statements:

a. The entity's creditors do not need or require financial statements prepared in accordance with GAAP.

b. The cost of complying with GAAP would exceed the benefits (for example, a small construction contractor who would be required to account for long term contracts using the percentage of completion method and would be required to compute deferred taxes).

c. The owners are closely involved in the day-to-day operations of the business and have a fairly accurate picture of the entity's financial position.

d. The owners are primarily interested in cash flows (for example, a professional corporation of physicians that distributes its cash-basis earnings through salaries, bonuses, and retirement plan contributions).

e. The owners are primarily interested in the tax implications of transactions (for example, partners in a partnership who are concerned about the effects of transactions on their personal tax returns).

f. It may not be appropriate to prepare and issue cash- or tax-basis financial statements if the entity is or soon will be required to issue GAAP-basis financial statements. For example, management of a company that is anticipating selling its business may be required to issue financial statements prepared in accordance with GAAP.

Additionally, financial statements prepared when applying the cash- or tax-basis of accounting should not be issued if the results are misleading. Cash- and tax-basis financial statements are intended to be a cost-effective alternative to GAAP, not a way to deliberately mislead financial statement users.

Example

Situation In Which it May Not Be Prudent to Issue Tax-Basis Financial Statements

Long Street Partners has typically issued tax-basis financial statements because the partners are more interested in the tax treatment of partnership transactions. Outside creditors have also accepted the tax-basis financial statements as suitable for their needs. During the current year, two events occur that significantly affect the partnership:

- Several large customers experience financial difficulty and the partnership's receivables from the customers are in danger of not being collected. If the financial statements were prepared in accordance with GAAP, the partnership would be required to record a valuation allowance and recognize a bad debt expense. Under the tax rules, the partnership uses the direct write-off method, so a tax deduction may not be allowed in the current year.
- The partnership has acknowledged that it is obligated to perform an environmental remediation at one of its sites. If the financial statements were prepared in accordance with GAAP, the partnership would be required to recognize the liability and a loss. Although the entity may disclose the information in a risks and uncertainties note, under the tax rules, the deduction is not allowed until the amount is paid and therefore would not be included in the income statement equivalent.

Prior to preparing and issuing tax-basis financial statements, in determining whether the proposed financial reporting framework is appropriate, the preparer may consider the following:

- *Whether the tax-basis financial statements continue to be suitable for the users' needs.* In the example, the entity had a long history of issuing tax-basis financial statements, which were suitable for the needs of the users. The events in the current year merely illustrate the limitations of tax-basis financial statements.
- *Appropriateness of disclosure.* The preparer may determine to expand on the information included in the notes to the financial statements about these two events. For example, the partnership might disclose the nature of the environmental remediation liability and the amounts involved.
- *Recognition may be appropriate.* Depending on the nature and magnitude of the item, it may be appropriate to recognize it in the financial statements. In this example, the partnership might decide to account for bad debts using the allowance method and to recognize a contingent liability for the remediation obligation. This would be a departure from the tax-basis of accounting and the management of the entity may determine that, in the circumstances, it may be more appropriate to prepare its financial statements in accordance with GAAP.
- *Consider GAAP financials.* As a result of the changed circumstances, financial statements prepared when applying the cash- or tax-basis of accounting may no longer be appropriate, and the management of the entity may decide to prepare its financial statements in accordance with GAAP.

Deciding Between Modified Cash- or Accrual Tax-Basis Financial Statements

In some situations it may be difficult to determine whether to issue modified cash- or accrual tax-basis financial statements. Each basis has its own distinct advantages and disadvantages.

Modified Cash- or Accrual Tax-Basis
Advantages and Disadvantages of Each

Advantages	*Disadvantages*
Modified Cash-Basis	
• Can be simpler to prepare than tax-basis	• Recognition and measurement principles are not well-defined
• Not affected by changes in tax laws	• Not well-suited for entities that have inventory or complex operations
• Interim financial statements are easy to prepare	
Accrual Tax-Basis	
• Better-suited for entities with inventory or complex operations	• Decisions made for tax reporting purposes may have unintended financial reporting effects
• Well-defined recognition and measurement criteria	• Accounting treatments are affected by changes in tax laws

Chapter 2

Recognition and Measurement Issues in Financial Statements Prepared When Applying the Cash- or Tax-Basis of Accounting

The determination of *what* information should be reported in the financial statements and *when* to recognize transactions or events (recognition), and *how* to record transactions or events and at what amounts (measurement) varies depending on the type of framework used to prepare the financial statements. This chapter includes a discussion of recognition and measurement issues for cash-, modified cash-, and tax-basis financial statements.

Cash-Basis and Modified Cash-Basis

Practice Tip

In accordance with the master glossary included in the Financial Accounting Standards Board *Accounting Standards Codification™, cash equivalents* are short-term, highly liquid investments that have both of the following characteristics:

a. Readily convertible to known amounts of cash

b. So near their maturity that they present insignificant risks of changes in value because of changes in interest rates

Generally, only investments with original maturities of three months or less qualify under that definition. Original maturity means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill and a three-year U.S. Treasury note purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months. Examples of items commonly considered to be cash equivalents are Treasury bills, commercial paper, money market funds, and federal funds sold (for an entity with banking operations).

The following represents certain significant measurement and recognition issues with respect to the cash and modified cash bases of accounting.

Investments

In accordance with the cash-basis of accounting, entities would reflect purchases of investments as cash disbursements and sales of investments as cash receipts in the period that the cash is disbursed or received. Investments acquired via noncash transactions should not be recorded and unrealized gains and losses should not be recognized.

A common modification to the cash-basis of accounting is to record investments in marketable securities as assets. If the entity prepared its financial statements in accordance with accounting principles generally accepted in the United States of America (GAAP), the investments would be reflected in the balance sheet. As such, the investments would be initially recorded at cost and subsequent unrealized changes in value would be recorded to reflect the fair value of the investments. Because unrealized gains and losses are not the result of a cash transaction or event, such unrealized gains and losses should not be recorded in financial statements when applying a modified cash-basis of accounting. Instead, the investments would remain on the balance sheet equivalent at cost unless and until they become worthless or are sold.

Receivables

Receivables should not be recognized in financial statements prepared when applying the cash basis of accounting unless the receivables result from an outflow of cash. Other receivables such as those arising from sales transactions made on credit should not be recorded.

Property and Equipment

Under the cash-basis of accounting, purchases of property and equipment would be reflected in the financial statements as cash disbursements in the period the transaction occurred. The assets would not be capitalized and depreciation would not be recorded.

A common modification to the cash-basis of accounting is to record property and equipment arising from cash transactions as assets. Once the modification is made, the entity should adopt and consistently apply an allocation policy (depreciation or amortization) that has substantial support in the accounting literature and is logical. Such policy should also include recording any financing arrangements that are part of a cash transaction. As part of this policy, management of the entity should consider how it would address single-step transactions or events that may not directly involve a cash inflow or outflow but may nevertheless be recorded as an in-substance two-step cash transaction or event. See chapter 1, "Overview of Cash- and Tax-Basis Financial Statements," for discussion of in-substance two-step transactions.

Donated assets should not be recognized as "assets" because they are not derived from the use of cash or cash equivalents.

It would be appropriate to write off any remaining carrying value of property and equipment once the assets are no longer in use or have been permanently impaired.

Bank Overdrafts

Bank overdrafts may be netted with other cash balances from the same bank. Bank overdrafts should not be netted against funds held at another financial institution. If the entity has an overall negative cash balance from a financial institution, when applying the cash-basis of accounting, the negative cash balance would be shown as a liability on the balance sheet equivalent, if one is presented. For example, if the net balance in Bank A is $(1,000) and the net balance in Bank B is $5,000, the balance sheet equivalent would show a cash asset of $5,000 and the $(1,000) overdraft as a liability. If the entity has an overall global negative cash balance, the negative cash balance would be shown as negative cash on hand at the end of the period on the statement of cash receipts and disbursements.

Borrowings

When applying the cash-basis of accounting, the entity should record all proceeds from borrowings as cash receipts when received and then reflect the principal repaid and associated interest as cash disbursements when paid. If a loan provides direct financing of an asset, neither the loan nor the asset should be recorded. However, the principal and interest payments would be reflected as cash disbursements when paid. See chapter 1 for discussion of in-substance two-step transactions.

Tax-Basis

In tax-basis financial statements, transactions are recognized and measured in the same manner as they are in the entity's federal tax return. Therefore, the preparer of financial statements when applying the tax-basis of accounting is required to understand the federal tax laws applicable to the particular entity. Although this chapter highlights certain common measurement and recognition issues with respect to the tax-basis of accounting, it is not a substitute for understanding the federal tax laws applicable to the particular entity.

Additionally, although the IRS permits all entities to use the accrual method of accounting for tax purposes, many smaller entities can instead elect to use the cash method of accounting for tax purposes. Entities with inventories are required to use the accrual method for sales and purchases of inventory.

Nontaxable Revenues and Nondeductible Expenses

Under federal income tax laws, certain revenue is not taxable and certain expenses are not deductible. For example, receipts such as interest on obligations of state and local governments and proceeds from life insurance policies are not taxable. Costs such as premiums paid on officers' life insurance policies are not deductible. When presenting tax-basis financial statements, in order to be transparent, preparers of tax-basis financial statements may recognize nontaxable revenues and nondeductible expenses outside of taxable income.

Nontaxable revenues should be recognized when received (cash-basis) or when earned (accrual basis). Nondeductible expenses should be reported and charged to expense in the period paid (cash-basis) or when incurred (accrual basis).

Additional Income Taxes for Prior Years

An IRS exam may result in additional income taxes being assessed for prior years. Two alternative methods may be used to account for additional taxes for prior years.

- The amount may be charged to expense in the current period if there are no corresponding adjustments to the balance sheet equivalent for expenses capitalized or revenue recognized.
- The amount may be treated as a prior period adjustment and charged to retained earnings in a manner that is logical and consistent with the equivalent of a presentation in accordance with GAAP.

The IRS may disallow amounts charged to expense in prior years and require those amounts to be capitalized and amortized or may require recognition of previously unreported revenue. Such amounts, net of income tax adjustments, should be treated as prior period adjustments. Otherwise, either of the preceding methods is considered acceptable. The method used and the amount of additional taxes should be disclosed in the notes to the financial statements.

Accounting Changes for Tax Purposes

For tax purposes, the effects of an accounting change may be recognized prospectively over a specified number of years. Accounting changes should be treated in the same manner as they are treated in the tax return.

S Corporations

Income of an S corporation is taxable to its shareholders. Consequently, such a corporation may be required to maintain information on distinct classes of retained earnings. However, in tax-basis financial statements, S corporations usually report retained earnings as a single amount and should report distributions to stockholders.

Significant Differences Between GAAP and Tax-Basis

There are many differences between the way items are accounted for in accordance with GAAP and the way they are treated under the tax rules. Some of the more common include the following:

- Bad debt losses on uncollectible receivables
- Inventory capitalization and valuation
- Unrealized gains on investment securities
- Depreciation and impairment of capital assets
- Fair value measurements
- Consolidation

Chapter 3

Presentation and Disclosure Issues In Financial Statements Prepared When Applying The Cash- or Tax-Basis of Accounting

The determination of the form and content of the financial statements or *which* financial statements to present and *what* to include (presentation and disclosure) varies depending on the financial reporting framework applied.

Financial statements prepared when applying the cash- or tax-basis of accounting may provide less complex and more understandable alternatives to financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). However, preparers must be knowledgeable of GAAP disclosure requirements because cash- and tax-basis financial statements should include informative disclosures similar to those required by GAAP if the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP.

Practice Tip

Often, preparers of cash- and tax-basis financial statements elect to omit substantially all disclosures required by the cash- or tax-basis of accounting. The omission of disclosures is a departure from the cash- or tax-basis of accounting and, if such disclosures were included in the financial statements, they might influence the user's conclusions about the entity's financial position, results of operations, and cash flows. However, the omission may not necessarily result in misleading financial statements provided that the intended users are informed about such matters.

If cash- or tax-basis financial statements contain items for which GAAP would require disclosure, the financial statements may either provide the relevant disclosure that would be required for those items in a GAAP presentation or provide information that communicates the substance of that disclosure. This may result in substituting qualitative information for some of the quantitative information required for GAAP presentations. For example,

- disclosure of the repayment terms of significant long-term borrowings may sufficiently communicate information about future principal reduction without providing the summary of principal reduction during each of the next five years.
- information about the effects of accounting changes, discontinued operations, and extraordinary items could be disclosed in a note to the financial statements without following the GAAP presentation requirements in the income statement equivalent or disclosing net-of-tax effects.
- instead of showing expenses by their functional classifications with respect to the financial statements of a not-for-profit organization, a statement of activities could present expenses according to their natural classifications, and a note to the financial statements could use estimated percentages to communicate information about expenses incurred by the major program and supporting services.
- instead of showing the amounts of, and changes in, the unrestricted and temporarily and permanently restricted classes of net assets with respect to the financial statements of a not-for-profit organization, a statement of assets, liabilities, and net assets could report total net assets or fund balances, a related statement of activities could report changes in those totals, and a note to the financial statements could provide information, using estimated or actual amounts or percentages, about the restrictions on those amounts and on any deferred restricted amounts, describe the major restrictions, and provide information about significant changes in restricted amounts.

For financial statements prepared when applying the cash- or tax-basis of accounting, GAAP disclosure requirements that are not relevant to the measurement of the item need not be considered. To illustrate,

- fair value disclosures for investments in debt and equity securities would not be relevant when the basis of presentation does not adjust the cost of such securities to their fair value.
- disclosures related to actuarial calculations for contributions to defined benefit plans would not be relevant in financial statements prepared when applying the cash- or tax-basis of accounting.
- disclosures related to the use of estimates would not be relevant in a presentation that has no estimates, such as the cash- or modified cash-basis of accounting.

Financial statements prepared when applying the cash-basis of accounting generally do not include a statement of cash flows. However, depending on the user's requirements, financial statements prepared when applying a modified cash- or the tax-basis of accounting may include a statement of cash flows. For example, it may be challenging for users to obtain accurate information on operating, investing, and financing activities in single-year financial statements prepared when applying the tax-basis of accounting unless a statement of cash flows is presented.

Similar to financial statements prepared in accordance with GAAP, in order to achieve fair presentation, financial statements prepared when applying the cash- or tax-basis of accounting should include all informative disclosures that are appropriate for the applicable financial reporting framework, including all significant matters that materially affect the financial statements' use, understanding, and interpretation.

Additionally, because financial statements prepared when applying the cash- or tax-basis of accounting have certain inherent presentation and disclosure limitations, in order to enhance the value and usefulness of such financial statements, the preparer may disclose additional information in the notes to the financial statements. For example, donated capital assets would not be included in the balance sheet equivalent in financial statements prepared when applying a modified cash-basis of accounting—even if the modification to the cash-basis of accounting is to record capital expenditures as assets and depreciate them over their estimated useful lives. The preparer may elect to disclose the value of such donated capital assets in the notes to the financial statements.

Presentation—Cash-Basis Financial Statements

Because a balance sheet equivalent would simply show the cash balance and a corresponding equity account, and a statement of cash flows would be repetitive of the statement of cash receipts and disbursements, financial statements prepared when applying the cash-basis of accounting may consist only of a statement of cash receipts and disbursements. Although a single statement may be presented, informative disclosures are still necessary. Additionally, restrictions on cash balances should either be presented on the face of the statement of cash receipts and disbursements or should be disclosed in the notes to the financial statements.

Basis of Accounting

A required disclosure for all cash- and tax-basis financial statements is the description of the basis of accounting (financial reporting framework), including how that basis of accounting differs from GAAP. Although these differences from GAAP should be qualitatively described, they need not be quantified. This description is important in financial statements prepared when applying a modified cash-basis of accounting because such financial statements may vary depending on the modifications to the cash-basis that were made. The description therefore becomes essential to the user's understanding of the financial statements.

The description of the basis of accounting is usually presented in the summary of significant accounting policies section of the notes to the financial statements with a heading such as "Basis of Accounting." The following examples represent how the basis of accounting may be disclosed in the notes to financial statements prepared when applying the cash-, a modified cash-, and the tax-basis of accounting.

Example: Basis of Accounting Note—Cash-Basis of Accounting

Basis of Accounting

The financial statements of Company X have been prepared on the cash-basis of accounting, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America (GAAP). The cash-basis of accounting differs from GAAP primarily because revenues are recognized when received rather than when earned and expenses are recorded when paid rather than when incurred. The financial statements therefore present only cash and cash equivalents and changes therein in the form of cash receipts and disbursements.

Example: Basis of Accounting Note—Modified Cash-Basis of Accounting

Basis of Accounting

The financial statements of Company X have been prepared on the cash-basis of accounting, modified to record assets or liabilities with respect to cash transactions and events that provide a benefit or result in an obligation that covers a period greater than the period in which the cash transaction or event occurred. The modifications result in the recording of investments, inventories, capital assets, and related short-term and long-term obligations on the statement of financial position. This method of accounting represents a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America (GAAP). This basis of accounting differs from GAAP primarily because certain revenue and related assets (such as accounts receivable and revenue for billed or provided services not yet collected, and other accrued revenue and receivables) have been recognized when received rather than when earned and certain expenses and related liabilities (such as accounts payable and expenses for goods or services received but not yet paid, and other accrued liabilities and expenses) have been recognized when paid rather than when the obligations were incurred.

Example: Basis of Accounting Note—Tax-Basis of Accounting

Basis of Accounting

The financial statements of Company X have been prepared on the accrual basis of accounting that the Company uses for filing its federal income tax return, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America (GAAP). This basis differs from GAAP primarily because the Company expenses the cost of certain types of assets in accordance with Section 179 of the U.S. Internal Revenue Code (IRC). GAAP requires that such assets be capitalized and expensed over their estimated useful lives.

Summary of Significant Accounting Policies

Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 235, *Notes to Financial Statements*, requires that financial statements prepared in accordance with GAAP include a summary of significant accounting policies in the notes to the financial statements. Accordingly, cash- and tax-basis financial statements should include a summary of significant accounting policies in the notes to the financial statements.

In addition to the basis of accounting discussed previously, the note should include disclosure of the significant accounting policies used to prepare the financial statements, including policies that involve the following:

- A selection from existing acceptable alternatives
- Industry specific applications
- Unusual or innovative applications of accounting principles

Because the cash-basis of accounting does not include the recognition of noncash assets, liabilities, and noncash transactions, elaborate accounting policy disclosures are usually unnecessary. In financial statements prepared when applying a modified cash-basis of accounting, such disclosures may include information about the following:

- Investments
- Inventory
- Property and equipment
- Income taxes

- Consolidation
- Related parties and related party transactions
- Commitments and contingencies
- Uncertainties
- Subsequent events
- Asset impairments

The significant accounting policies note for tax-basis financial statements should include disclosure of the following:

- Whether the basic method of accounting is cash or accrual
- The tax filing status of the entity, if other than a taxable corporation (that is, a C corporation)
- That revenues and related assets and expenses and related obligations are recognized only when they are reported or deducted for federal income tax purposes
- That nontaxable income and nondeductible expenses are included in the determination of the equivalent of operating results or "net income"
- The nature of any optional tax methods of accounting followed
- The nature of any important judgments or policies necessary for an understanding of the methods of recognizing revenue and allocating costs to current and future periods
- Tax uncertainties including open tax years

Also, tax uncertainties should be addressed in financial statements prepared when applying the cash- or tax-basis of accounting. FASB ASC 740-10-50-15 requires that open tax years be disclosed—even if the reporting entity is a pass-through entity or a not-for-profit organization.

In addition, in financial statements prepared when applying the tax-basis of accounting, disclosures regarding significant accounting policies may include information about receivables.

The following represents guidance on certain other common presentation and disclosure issues with respect to cash- and tax-basis financial statements.

Subsequent Events

FASB ASC 855, *Subsequent Events*, sets forth general standards of accounting for and disclosure of events that occur after the balance sheet date but before the financial statements are issued or are available to be issued. The preparer should disclose the date through which subsequent events have been evaluated, which is the date the financial statements are available to be issued. When financial statements prepared when applying the cash- or tax-basis of accounting contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, such financial statements should contain the disclosures required by FASB ASC 855.

Related Party Transactions

The existence of related party transactions that are material individually or in the aggregate and the nature and amounts of the transactions and balances should be disclosed. Note that the tax rules may define “related party” differently than how it is defined in accordance with GAAP. To avoid confusion on the part of users of the tax-basis financial statements, the GAAP definition of related party should be considered for all financial reporting purposes.

Commitments and Contingencies

The existence and nature of material commitments and contingencies should be disclosed in the notes to financial statements prepared when applying the cash- or tax-basis of accounting.

Pension Plans

The existence and nature of a pension plan should be disclosed in the notes to financial statements when applying the cash- or tax-basis of accounting.

Assets and Liabilities

Information disclosed for assets and liabilities commonly includes the following items:

- Restricted cash, segregated from cash available for current operations, with a description of the nature of the restriction
- The aggregate fair value of investments in marketable securities

- Accounts and notes receivable from officers, employees, and affiliates, presented separately with disclosure of the effective interest rate on notes receivable, and interest income for the period
- The major classes of property, plant, and equipment; depreciation expense for the period; the method(s) used in computing depreciation; and the aggregate, accumulated depreciation
- The method of determining inventory cost (for example, last in, first out and first in, first out)

Owners' Equity

The financial statements often include disclosures regarding information on owners' equity as follows:

- For each class of stock, the number of shares authorized, issued, and outstanding; the par or stated value; and, in summary form, the pertinent rights and privileges of each outstanding class (if more than one class is outstanding)
- The existence of stock option and stock purchase plans
- Restrictions on the payment of dividends
- Changes for the period in the separate components of owners' equity

A note to the financial statements of a voluntary health and welfare organization that prepares tax-basis financial statements could provide information, using estimated or actual amounts or percentages, about the restrictions on total net assets or fund balances and on any deferred restricted amounts, describe the major restrictions, and provide information about significant changes in restricted amounts.

Risks and Uncertainties

Financial statements prepared in accordance with GAAP are required to include a number of disclosures with respect to risks and uncertainties.

The following table summarizes these disclosures and how GAAP requirements for disclosing risks and uncertainties should be addressed in cash- and tax-basis financial statements. The table is not meant to be all-inclusive.

Practice Tip

Often, preparers of cash- and tax-basis financial statements elect to omit substantially all disclosures required by the cash- or tax-basis of accounting. The omission of disclosures is a departure from the cash- or tax-basis of accounting and, if such disclosures were included in the financial statements, they might influence the user's conclusions about the entity's financial position, results of operations, and cash flows. However, the omission may not necessarily result in misleading financial statements provided that the intended users are informed about such matters.

GAAP Requirement	*Summary of Required Disclosures*	*Applicability to Cash- or Tax-Basis of Accounting*
Nature of Operations	Entities should disclose a description of the major products or services the reporting entity sells or provides and its principal markets. This information is useful because it helps financial statement users understand the nature of the entity's business and the risks common to that business.	This disclosure is relevant to all financial statements prepared in accordance with the cash- or tax-basis of accounting and should be made.
Use of Estimates	Financial statements should include an explanation that the preparation of financial statements in accordance with GAAP requires the use of management's estimates.	This disclosure may not be relevant to some financial statements prepared in accordance with the cash- or tax-basis of accounting; for example, financial statements prepared on the cash-basis that do not include estimated amounts.
Certain Significant Estimates	If certain criteria are met, the entity is required to disclose the nature of an uncertainty if it is at least reasonably possible that a change in an estimate will occur in the near term. The purpose of the disclosure is to communicate to financial statement users that there is a reasonable possibility that certain estimated amounts in the current year financial statements will change significantly and affect the subsequent years' financial statements.	If the GAAP disclosure criteria are met, the financial statements should include disclosure of the information required by GAAP.

(continued)

Vulnerability Due to Concentrations	If certain criteria are met, the financial statements are required to include disclosure information about its vulnerability due to concentrations; for example, significant volume of business conducted with one customer.	If the GAAP disclosure criteria are met, the preparer should disclose the information required by GAAP.
Going Concern	A basic premise underlying financial reporting is that a user of the financial statements can assume that the entity will continue as a going concern for a reasonable period of time. If the preparer concludes that material uncertainties exist such that the entity may not continue as a going concern for a reasonable period of time, the financial statements should include disclosure of such uncertainty.	If the preparer concludes that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time (generally one year from the date of the balance sheet equivalent), the preparer should disclose the going concern considerations in a note to the financial statements.

Terminology for Cash- and Tax-Basis Financial Statements

Because terms such as *balance sheet, statement of financial position, statement of income, statement of operations,* and *statement of cash flows*, or similar unmodified titles are generally understood to be applicable only to financial statements that are intended to present financial position, results of operations, or cash flows in conformity with GAAP, such unmodified financial statement titles should not be used in financial statements prepared when applying the cash- or tax-basis of accounting. A modification may be as simple as adding "cash-basis," "modified cash-basis," or "tax-basis" after the financial statement title.

Cash-basis financial statements might be titled, for example,

- statement of assets and liabilities arising from cash transactions;
- statement of revenue collected and expenses paid;
- statement of revenue and expenses—cash-basis; or
- statement of receipts and disbursements.

Modified cash-basis financial statements might be titled, for example,

- statement of assets and net assets—modified cash-basis; or
- statement of revenue, expenses and changes in net assets—modified cash-basis.

Tax-basis financial statements might be titled, for example,

- statement of assets, liabilities, and capital—tax-basis;
- statement of operations—tax-basis; or
- statement of revenue and expenses—tax-basis.

The preceding examples are not meant to be all-inclusive and are not the only acceptable titles.

The selection of specific financial statement titles is a matter of judgment and any modified title would be appropriate as long as it is made clear to users that the financial statements are not prepared in accordance with GAAP.

With respect to the captions to be used with the cash-, modified cash-, or tax-basis financial statements, there is no requirement to modify the standard GAAP financial statement captions. Therefore, captions such as "net income," "net loss," and "retained earnings" are acceptable. However, if modifications are desired (which many preparers prefer as a means of additional emphasis that the financial statements are not prepared in accordance with GAAP), common examples for cash-basis financial statements are *excess of revenue collected over expenses paid and excess of expenses paid over revenue collected*. For financial statements prepared when applying a modified cash-basis of accounting, common modifications *are excess of revenue over expenses and excess of expenses over revenue*. With respect to tax-basis financial statements, modifications with respect to financial statement captions are rarely made. However, modifications, if made, may include *retained earnings—tax-basis and net income—tax-basis*.

Consolidation Accounting

Professional judgment should be applied to determine which presentation—consolidated, unconsolidated, or combined—provides the most meaningful and relevant information. A preparer should not consolidate entities unless all entities to be consolidated use the same basis of accounting. For example, it would not be appropriate to consolidate an entity that prepares its financial statements using a modified cash-basis of accounting with its parent who maintains its books and records in accordance with the tax-basis of accounting. If the modified cash-basis of accounting is used, then all consolidated entities should utilize the same modifications to the cash-basis of accounting.

With respect to financial statements prepared when applying the tax-basis of accounting, consolidation is based on the IRC. Therefore, the consolidation requirements of FASB ASC 810, *Consolidation*, do not apply. However, if the entity files a consolidated tax return, it should report consolidated results on its tax-basis financial statements. In the case of brother-sister corporations in which each entity maintains its books and records on the tax-basis of accounting, but a consolidated tax return is not filed, the preparer may prepare combined financial statements because such financial statements may be more useful to users than individual uncombined financial statements.

Although the tax consolidation rules are followed, additional disclosures may be necessary to lessen the chance that the financial statements are not misleading. Consider, for example, a 60 percent owned subsidiary that would be consolidated in financial statements prepared in accordance with GAAP but is not consolidated in financial statements prepared when applying the tax-basis of accounting because the threshold for consolidation under the IRC is 80 percent ownership. Even though the subsidiary is not consolidated, the preparer should consider which disclosures are appropriate relative to the 60 percent owned subsidiary. Examples of matters that might require disclosure are the ownership and relationship with the subsidiary, related party transactions, guarantees, and commitments.

Change From GAAP to Cash- or Tax-Basis

A change from GAAP to cash- or tax-basis statements (or vice versa) does not represent a change in accounting principles as described in FASB ASC 250, *Accounting Changes and Error Corrections*. Therefore, no justification for the change is required, and a cumulative effect adjustment is unnecessary. When only the current year's cash- or tax-basis statements are presented, there are three ways of presenting opening equity:

- Show opening equity as previously reported in accordance with GAAP, with an adjustment to convert to the cash- or tax-basis.
- Show opening equity on the as-adjusted cash- or tax-basis.
- Show the effects of the adjustment to convert as a cumulative-effect adjustment in the income statement equivalent.

If comparative financial statements are presented, the prior periods should be restated and presented on the basis to which the company has changed. Restatement is necessary to ensure comparability between all periods presented.

In all cases, the change in accounting basis should be disclosed in the notes to the financial statements. The following is an example of how such a change in accounting basis could be disclosed in the notes to the financial statements:

> In 20X1, management adopted a policy of preparing its financial statements on the basis of accounting that it uses to file its federal income tax return. Prior to 20X1, the Company's financial statements were prepared in accordance with accounting principles generally accepted in the United States of America. Management believes that this change results in more relevant financial reporting that is easier and less costly to understand, apply, and use in the Company's circumstances and considering the needs of the users of the financial statements. The 20X1 financial statements have been restated to be on the tax-basis of accounting.

Appendix

Illustrative Cash- and Tax-Basis Financial Statements

This appendix contains illustrative examples of financial statements prepared when applying the cash-, modified cash-, or tax-basis of accounting for different types of entities. These financial statements are intended to illustrate the significant discussion points in chapters 1–3 of this practice aid. Each financial statement has been annotated to highlight these key points.

Name of Entity	*Type of Entity*	*Basis of Preparation*
Ceolainn Club	Not-for-profit	Cash
Mickey's Center	Not-for-profit	Modified Cash
Donnelly & Oates	Limited Liability Partnership	Tax (Accrual Basis)
Charlton Contractors, Inc.	Construction Contractor	Tax (Accrual Basis)
Margaret Rose 1964 Irrevocable Trust	Trust	Tax (Accrual Basis)

CEOLAINN CLUB
FINANCIAL STATEMENTS
FOR THE YEARS ENDED
JUNE 30, 20X2 AND 20X1

Circumstances include the following:

- The financial statements are for a not-for-profit membership club.
- The financial statements are prepared on the cash-basis of accounting.
- The financial statements are comparative for the years ended June 30, 20X2, and 20X1.

The financial statements illustrate the following:

- The financial statements include a statement of functional expenses, which is required by accounting principles generally accepted in the United States of America (GAAP). Financial statements prepared when applying the cash-basis of accounting are not required to include such a statement, but may instead communicate the substance of that requirement.

▶ GAAP requires not-for-profit organizations to report the amount of unrestricted, temporarily restricted, and permanently restricted net assets on the face of the statement of financial position. Because a statement of financial position equivalent is not presented, the illustrative financial statements communicate the substance of the GAAP requirement in the notes to the financial statements.

Ceoliann Club
Statements of Cash Receipts and Disbursements
For the Years Ended June 30, 20X2 and 20X1

	June 30, 20X2	*June 30, 20X1*
Cash received from support activities:		
Membership dues	$ 49,899	$ 46,759
Donations	996	1,125
Programs	7,495	10,645
Total cash received from support activities	58,390	58,529
Cash received from other sources:		
Interest income	19	30
Other	300	3,720
Total cash received from other sources	319	3,750
TOTAL CASH RECEIVED	**$ 58,709**	**$ 62,279**
Cash disbursed:		
Program services	$ 29,110	$ 29,484
Supporting services	19,783	19,113
Fundraising	6,288	8,803
TOTAL CASH DISBURSED	**$ 55,181**	**$ 57,400**
Excess of revenue collected over expenses paid	**3,528**	**4,879**
Cash and cash equivalents, beginning of year	39,046	34,167
Cash and cash equivalents, end of year	$ 42,574	$ 39,046

See accompanying notes to financial statements.

The Ceoliann Club
Statements of Functional Expenses Cash-Basis
For the Years Ended June 30, 20X2 and 20X1

	Program Services	*Supporting Services*	*Fundraising*	*Total June 30, 20X2*	*Program Services*	*Supporting Services*	*Fundraising*	*Total June 30, 20X1*
Salaries and benefits	$ 23,333	$ 16,440	$ 4,241	$ 44,014	$ 23,633	$ 15,876	$ 5,937	$ 45,446
Events—special			1,795	1,795			2,513	2,513
Legal and accounting		2,320		2,320		2,500		2,500
Insurance	313	51	45	409	317	49	63	429
Postage/printing	3,477			3,477	3,398			3,398
Licenses/fees		114		114		464		464
Office expense	612	232	207	1.051	620	224	290	1,134
Miscellaneous	1,375	626		2,001	1,516			1,516
	$ 29,110	$ 19,783	$ 6,288	$ 55,181	$ 29,484	$ 19,113	$ 8,803	$ 57,400
	53%	36%	11%		52%	33%	15%	

See accompanying notes to financial statements.

Ceolainn Club
Notes to Financial Statements
Cash-Basis
For the Years Ended June 30, 20X2 and 20X1

Note 1—Summary of Significant Accounting Policies

Nature of Activities
The Ceolainn Club (the Club) is a New York not-for-profit organization. The Club's mission is to promote safe social programs for young adults.

Basis of Accounting
The Club's financial statements have been prepared on the cash-basis of accounting, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America (GAAP). The cash-basis of accounting differs from GAAP primarily because revenues are recognized when received rather than when earned and expenses are recorded when paid rather than when incurred. The financial statements therefore present only cash and cash equivalents and changes therein in the form of cash receipts and disbursements.

Cash and Cash Equivalents
The Club considers all highly liquid investments available for current use with an initial maturity of three months or less to be cash equivalents. As of June 30, 20X2, and 20X1, cash and cash equivalents consisted entirely of the adjusted book balance in the Club's checking account.

Net Assets
As of June 30, 20X2, and 20X1, all of the Club's net assets were unrestricted.

Income Taxes
The Club is exempt from federal and state income taxes under Internal Revenue Code Section 501(c)(7). Accordingly, no provision for income taxes has been made in the financial statements.

Uncertain Tax Positions
Federal and state income tax returns for the years 20X0 to date are subject to examination by taxing authorities.

Subsequent Events
Management has evaluated subsequent events through August 28, 20X2, which is the date the financial statements were available to be issued.

MICKEY'S CENTER
FINANCIAL STATEMENTS
AS OF AND FOR THE YEAR ENDED
AUGUST 31, 20X2

Circumstances include the following:

- The financial statements are for a not-for-profit charity.
- The financial statements are prepared on a modified cash-basis of accounting. The cash-basis of accounting was modified to accrue cash transactions and events that provide a benefit or result in an obligation that covers a period greater than the period in which the cash transactions or events occurred. Such accruals resulted in the recording of property and equipment as assets on the statement of assets and net assets and subsequent depreciation of those assets over their estimated useful lives.
- The financial statements are as of August 31, 20X2, and for the year then ended.

The financial statements illustrate the following:

- The financial statements include a statement of functional expenses, which is required by accounting principles generally accepted in the United States of America (GAAP). Financial statements prepared when applying a modified cash-basis of accounting are not required to include such a statement, but may instead communicate the substance of that requirement.
- GAAP requires not-for-profit organizations to report the amount of unrestricted, temporarily restricted, and permanently restricted net assets on the face of the balance sheet (in the case of the illustrative financial statements prepared on a modified cash-basis of accounting, such point in time statement is referred to as the statement of assets and net assets). The illustrative financial statements do not follow those presentation requirements but instead, communicate their substance by providing relevant information in the notes to the financial statements.

Mickey's Center
Statement of Assets and Net Assets
Modified Cash-Basis
August 31, 20X2

Assets	
Cash and cash equivalents	$ 316,258
Restricted cash (Note 2)	108,084
Property and equipment (net of accumulated depreciation of $35,565)	9,018
	$ 433,360
Net Assets	
Unrestricted net assets (Note 5)	433,360
Net assets	$ 433,360

See accompanying notes to financial statements.

Mickey's Center
Statement of Revenue, Expenses and Changes in Net Assets
Modified Cash-Basis
For the Year Ended August 31, 20X2

Revenue	
Corporate and foundation contributions	$ 536,134
Other contributions	235,920
Exchange club projects	105,302
Unsolicited and other donations	69,754
Total revenue	947,110
Expenses	
Program services	769,426
Management and general	100,718
Fundraising	55,264
	155,982
Total expenses	925,408
Increase in net assets	21,702
Net assets, beginning of year	411,658
Net assets, end of year	$ 433,360

See accompanying notes to financial statements.

Mickey's Center
Statement of Functional Expenses
Modified Cash-Basis
For the Year Ended August 31, 20X2

	Program Services	*Management and General*	*Fundraising*	*Total*
Salaries and benefits	$ 451,675	$ 76,781	$ 38,041	$ 566,497
Grant expense	41,291			41,291
Special events	77,790	13,233	91,023	
Training	16,029			16,029
Professional services		16,810		16,810
Telephone	14,782	720	428	15,930
Postage/printing	6,176	301	178	6,655
Office supplies	16,597	809	481	17,887
Program materials	16,279			16,279
Depreciation	8,917	435	259	9,611
Rent	58,084	2,831	1,683	62,598
Miscellaneous	61,806	2,031	961	64,798
	$ 769,426	$ 100,718	$ 55,264	$ 925,408
	83%	11%	6%	

See accompanying notes to financial statements.

Mickey's Center
Notes to Financial Statements
Modified Cash-Basis
August 31, 20X2

Note 1—Summary of Significant Accounting Policies

Nature of Activities

Mickey's Center (the Center) is a nonprofit corporation incorporated under the Texas Non-Profit Corporation Act. The purpose of the Center is to use its funds exclusively for charitable, scientific, and educational purposes, especially the prevention of child abuse.

Basis of Accounting

The financial statements of the Center have been prepared on the cash-basis of accounting, modified to record assets or liabilities with respect to cash transactions and events that provide a benefit or result in an obligation that covers a period greater than the period in which the cash transactions or events occurred. The modifications result in the recording of capital assets on the statement of assets and net assets. Except for depreciation, all transactions are recognized as either revenue or expenses when received or paid in cash. Except for depreciation, noncash transactions are not recognized. This basis of accounting represents a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America (GAAP). This basis of accounting differs from GAAP primarily because certain revenue and related assets have been recognized when received rather than when earned and certain expenses and related liabilities have been recognized when paid rather than when the obligations were incurred.

Property and Equipment
Property and equipment are recorded at cost and consist of the office building and equipment. Depreciation is computed on the straight-line method based on estimated useful lives of 30 years and 5 years for the office building and equipment, respectively.

Cash Equivalents
The Center considers all highly liquid debt instruments with an original maturity of three months or less to be cash equivalents.

Contributions
The Center records contributions when received in cash.

Contributed Services
Many individuals volunteer their time to help the Center with its educational activities. During the year ended August 31, 20X2, the Center received approximately 200 volunteer hours that have not been recorded in the statement of revenue, expenses, and changes in net assets.

Functional Expenses
The costs of providing the various programs, fundraising, and other activities have been summarized on a functional basis in the statement of functional expenses. Accordingly, certain costs have been allocated among the programs and fundraising activities benefited. Functional expenses are allocated to programs and supporting services based on specific identification. Expenses that relate to more than one program or support activity are allocated based on salary expenditure.

Income Taxes
The Center is exempt from federal and state income taxes under Internal Revenue Code Section 501(c)(3), except to the extent that it has taxable income from businesses that are not related to its tax exempt purpose. Unrelated business income, if there was any, would be taxed at the applicable corporate income tax rate. The Center did not have any unrelated business income during the year ended August 31, 20X2, and accordingly, no provision for income taxes has been made in the financial statements.

The Center is not currently under examination by any taxing jurisdiction. Federal and state taxing authorities no longer have the right to examine tax years prior to 20Y9. For the year ended August 31, 20X2, there were no interest or penalties associated with tax positions recorded in the accompanying financial statements.

Use of Estimates

The preparation of financial statements on a modified cash-basis of accounting requires management to make estimates and assumptions that affect financial statement amounts and disclosures. Actual results could differ from those estimates and assumptions.

Subsequent Events

In preparing these financial statements, management of the Center has evaluated events and transactions for potential recognition or disclosure through January 20, 20X3, the date the financial statements were available to be issued.

Note 2—Restricted Cash

The balance represents funds restricted by the board of directors in an amount equal to the balance in the School Initiatives Fund.

Note 3—Commitments and Contingencies

The land on which the Center's office is located is being leased on an annual basis at a rate of $1,400 per annum. See Note 4.

Note 4—Subsequent Events

In September 20X2, the Center entered into a "purchase and sale agreement," which provided for the purchase of a building in the amount of $230,000 and the assumption of a lease of the land on which the building is located. The building purchase was executed on September 28, 20X2, and was financed in part by a $220,000 note payable to a bank. The terms of the note provide for quarterly interest payments at the bank's prime rate through the note maturity date. A $100,000 principal payment was due and made in December 20X2, and the remaining balance is due September 20X8. The note is secured by a leasehold deed of trust and security agreement and an assignment of rents and leases.

The assumed lease previously referred to is an operating lease that requires annual payments of $19,600 through September 20X6. The Center has the option to terminate the lease in March 20X9. If the lease is not terminated, the annual payment will be revised to reflect 6 percent of the value of the land, which will be determined as set forth in the lease agreement.

In December 20X2, the Center entered into a construction contract for $138,000 to design and construct certain building and leasehold improvements.

Note 5—Internally Restricted Net Assets

Net assets internally restricted for the School Initiatives Fund consist of amounts allocated from unrestricted net assets as approved by the board of directors. The internally restricted amounts are to be used for purchasing equipment and establishing programs for educational programs in schools and are not available for other purposes without approval by the board of directors.

Note 6—Allocation of Joint Costs

During the year ended August 31, 20X2, the Center conducted activities that included appeals for contributions and incurred joint costs of approximately $46,000. These activities included direct mail campaigns and special events. Approximately 65 percent of these joint costs were allocated to fundraising activities and 35 percent to program services.

DONNELLY & OATES LIMITED LIABILITY PARTNERSHIP
FINANCIAL STATEMENTS
AS OF AND FOR THE YEAR ENDED
DECEMBER 31, 20X2

Circumstances include the following:

- The financial statements are for a limited liability partnership (LLP) that owns and operates a racquet and swim club.
- The financial statements are prepared on basis of accounting that the LLP uses for federal income tax purposes.
- The financial statements are as of and for the year ended December 31, 20X2.

The financial statements illustrate the following:

- The Statement of Revenues and Expenses uses the caption "Revenues in excess of expenses" to portray what a financial statement prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) would describe as "Net income." There is no prohibition on the use of "Net income" or other GAAP captions within the financial statements. In this situation, the entity has chosen the term because management believes it to be more descriptive.
- The financial statements include a Statement of Cash Flows, which is not required for financial statements prepared when applying the tax-basis of accounting. However, in this case, the financial statements include a single year only, thus it would be difficult for financial statement users to obtain accurately the information on operating, investing and financing activities presented in a statement of cash flows.

Donnelly & Oates Limited Liability Partnership
Statements of Assets, Liabilities and Partners' Capital
Tax-Basis
December 31, 20X2

Assets	
Cash	450,944
Accounts receivable	451,194
Inventory	311,214
Prepaid expenses and other assets	24,046
Financing fees, less accumulated amortization of $57,096	259,124
Syndication costs	312,166
Property and equipment, net of accumulated depreciation of $2,810,112	9,054,554
	$ 10,863,242
Liabilities and Partners' Capital	
Accounts payable	$ 276,502
Accrued payroll and related costs	117,792
Other accrued expenses	23,998
Unearned dues	369,586
Mortgage payable	$ 7,566,966
Total liabilities	8,354,844
Partners' capital	2,508,398
	$ 10,863,242

See accompanying notes.

Donnelly & Oates Limited Liability Partnership
Statement of Revenues and Expenses
Tax-Basis
For the Year Ended December 31, 20X2

Revenues	
Membership dues	$ 3,970,334
Initiation fees	389,638
Tennis court fees and lessons	1,103,224
Other income	726,936
Sports shop and café	1,219,740
Total revenues	6,708,072
Expenses	
Management fee	50,700
Maintenance and operating	504,448
Utilities	391,460
Advertising and promotions	191,088
Payroll and related costs	2,774,706
Insurance	136,984
Administrative	246,906
Real estate taxes	351,246
	701,800
Cost of sales—sports shop and café	
Total expenses	5,349,338
Net operating income	2,060,534
Partnership expenses	(9,572)
Interest expense	(765,476)
Depreciation and amortization	(610,094)
Loss on sale of equipment	(4,240)
Revenues in excess of expenses	$ 671,152

See accompanying notes.

Donnelly & Oates Limited Liability Partnership
Statement of Partners' Capital
Tax-Basis
For the Year Ended December 31, 20X2

	Limited Partners	*Special Limited Partner*	*General Partner*	*Partners' Capital*
Balance, December 31, 20X1	$ 1,017,392	$ 1,256,710	$ (69,276)	$ 2,204,826
Cash distributions	(238,924)	(55,138)	(73,518)	(367,580)
Revenues in excess of expenses	436,254	100,674	134,224	671,152
Balance, December 31, 20X2	$ 1,214,722	$ 1,302,246	$ (8,570)	$ 2,508,398

See accompanying notes.

Donnelly & Oates Limited Liability Partnership
Statement of Cash Flows
Tax-Basis
For the Year Ended December 31, 20X2

Cash flows from operating activities	
Revenues in excess of expenses	$ 671,152
Adjustments to reconcile revenues in excess of expenses to cash flows from operating activities	
Depreciation and amortization	610,094
Loss on sale of equipment	4,240
(Increase) decrease in:	
Accounts receivable	(23,494)
Inventory	(102,916)
Prepaid expenses	1,472
Accounts payable and accrued expenses	74,992
Unearned dues	32,874
Net cash flows provided by operating activities	1,268,414
Cash flows from investing activities	
Acquisition of equipment	(277,138)
Proceeds from sale of equipment	620
Net cash flows used by investing activities	(276,518)
Cash flows from financing activities	
Repayment of debt	(473,574)
Cash distributions to partners	(367,580)
Net cash flows used by financing activities	(841,154)
Increase in cash	150,742

(continued)

Donnelly & Oates Limited Liability Partnership
Statement of Cash Flows
Tax-Basis
For the Year Ended December 31, 20X2

Cash at beginning of year	300,202
Cash at end of year	$ 450,944
Supplemental disclosures of cash flow information:	
Cash paid during the year for interest	$ 774,170

See accompanying notes.

Donnelly & Oates Limited Liability Partnership
Notes to Financial Statements
Tax-Basis
For the Year Ended December 31, 20X2

Note 1—Summary of Significant Accounting Policies

Nature of Operations
The Partnership owns and operates a racquet and swim club (the Club) located in Minnesota.

The Club has approximately 3,000 members at December 31, 20X2. The Club extends credit to members for the payment of dues and other charges.

The Partnership, formed in 19W5, is a limited liability partnership in accordance with the provisions of the Uniform Partnership Act as in effect in the State of Minnesota.

The general partner of the Partnership is Tony Donnelly.

Basis of Accounting
The Partnership's financial statements are prepared on the accounting basis the Partnership used for federal income tax purposes, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America (GAAP). The Partnership uses the Accelerated Cost Recovery System (ACRS) and Modified Accelerated Cost Recovery System (MACRS) in depreciating its property. Under ACRS and MACRS, depreciation is determined over periods of time that are shorter than those used in accordance with GAAP. Additionally, the income tax methods used to capitalize and amortize amortizable assets differ from those used under GAAP.

Syndication costs are carried as an asset of the Partnership and are not amortized. Under GAAP these costs would be deducted from partners' capital.

Cash Equivalents
The Partnership considers all highly liquid investments with an original maturity of three months or less to be cash equivalents.

Concentration of Credit Risk
The Partnership places its cash with one banking institution. At times the amount on deposit exceeds the insured limit of the institution and exposes the Partnership to a collection risk.

Inventories
Inventories, which consist of merchandise for sale in the sports shop, food, and beverages, are stated at the lower of cost (first in, first out method) or market.

Membership Dues and Initiation Fees
Membership dues are billed in advance and recorded in accounts receivable and unearned dues. The dues are recognized as revenue in the month earned. Initiation fees are recorded as revenue in the period when the fee is collected.

Property and Equipment
Property and equipment are carried at depreciated cost. Depreciation is computed using income tax methods. The cost of maintenance and repairs is charged to income as incurred; significant renewals or betterments are capitalized.

Financing Fees
Financing fees are amortized over the term of the related debt using the straight-line method. During 20XX, financing fees related to retired debt were written off. The financing fees related to new debt were capitalized. Amortization expense was $12,149 during 20X2.

Start-Up Costs
Start-up costs are amortized over 60 months using the straight-line method.

Income Taxes
Income taxes on Partnership income are levied on the partners at the partner level. Accordingly, all profits and losses of the Partnership are recognized by each partner on his respective tax return.

Management believes that the Partnership has adequately addressed all relevant tax positions and that there are no unrecorded tax liabilities. Tax returns filed for the tax years ending from December 31, 20Y9, through current are still subject to examination by federal and state tax authorities. Any interest or penalties assessed to the Partnership are recorded in operating expenses. No interest or penalties from federal or state tax authorities were recorded in the accompanying financial statements.

Advertising and Promotions
Advertising costs are expensed as incurred. For the year ended December 31, 20X2, the Partnership incurred $191,088 in advertising costs.

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

Subsequent Events
Subsequent events have been evaluated through February 24, 20X3, which is the date the financial statements were available to be issued, and there are no subsequent events requiring disclosure.

Note 2—Partnership Organization

Profit and Loss Allocations
Prior to December 1, 20XX, profits and losses from annual operations were allocated 99 percent to the limited partners and 1 percent to the general partner.

Subsequent to November 30, 20XX, and until the Class A limited partners have received distributions of net cash flow equal to their preferred return, profits and losses from annual operations are allocated 65 percent to the Class A limited partners; 15 percent to the special limited partner; and 20 percent to the general partner.

After the Class A limited partners have received cumulative distributions of net cash flow equal to their preferred return, profits and losses from annual operations will be allocated 45 percent to the Class A limited partners; 15 percent to the special limited partner; and 40 percent to the general partner.

Net Cash Flow Allocation From Operations
Subsequent to November 30, 20XX, net cash flow is allocated 65 percent to the Class A limited partners; 15 percent to the special limited partner; and 20 percent to the general

partner until such time as the Class A limited partners have received cumulative distributions equal to their preferred return.

The balance of any net cash flow will be distributed 45 percent to the Class A limited partners; 15 percent to the special limited partner; and 40 percent to the general partner.

Preferred Return

The preferred return means a 9 percent per annum cumulative noncompounded return on the adjusted capital contribution of the Class A limited partners. The adjusted capital contribution means the original capital contributions are reduced only by distribution from the net proceeds of sale or refinancing.

Note 3—Property and Equipment

Property and equipment at December 31, 20X2, consisted of the following:

		Recovery Period-Years
Land	$ 975,720	—
Building	9,320,050	7–40
Tenant improvements	1,568,896	5–7
Total cost of property and equipment being depreciated	$ 11,864,666	
Less: Accumulated depreciation	2,810,112	
Total property and equipment, net	$ 9,054,554	

Depreciation expense was $597,945 during 20X2.

Note 4—Mortgage Payable

At December 31, 20X2, debt consisted of the following:	
Mortgage loan payable in monthly payments of $73,124, including interest at 9.375%, through January 20XY when the interest rate changes to 3.5% above the 3-year Treasury base rate. Beginning February 1, 20XY, monthly payments will be adjusted to reflect the new interest rate; the payments will be based upon a 15-year term. The remaining principal is due January 1, 20XZ. The mortgage is secured by property, equipment, and a personal guaranty.	$ 6,778,186
10% unsecured note payable to the special limited partners due in monthly installments of $16,546, including principal and interest, through February 1, 20XZ, when the unpaid balance is due.	788,780
	$ 7,566,966

Scheduled principal payments under these loans are approximately $380,000 per year until February 1, 20XY, when payment terms will be adjusted as described previously.

Note 5—Amendment of the Partnership Agreement

The Partnership agreement was amended effective November 30, 20XX. The primary purpose of the amendment was to create a new class of limited partner (the special limited partner) and to change the allocations of profits, losses, and cash distributions.

Effective November 30, 20XX, Michael Oates surrendered his 67 limited partnership units in exchange for $1,450,000 and a 15 percent special limited partnership interest. Additionally, as part of this exchange, $200,000 was paid down on the note payable to the special limited partner, the interest rate on this note was reduced to 10 percent from 12 percent, and the term of the note was shortened.

Note 6—Transactions With Affiliates

At December 31, 20X2, the Partnership owed partners or affiliated entities $788,780.

During 20X2 a management fee of $50,700 was paid to a partner.

CHARLTON CONTRACTORS, INC.
FINANCIAL STATEMENTS
AS OF AND FOR THE YEARS ENDED
DECEMBER 31, 20X2, AND 20X1

Circumstances include the following:

- The financial statements are for a general contractor. The general contractor has elected to be treated as a small business corporation (S corporation) under Internal Revenue Code Section 1362.
- The financial statements are prepared on the accrual method of accounting used for federal income tax purposes.
- The financial statements are comparative statements as of and for the years ended December 31, 20X2, and 20X1.

The financial statements illustrate the following:

- The financial statements include a statement of cash flows, which is not required for financial statements prepared when applying the tax-basis of accounting.

- Information about contract receivables (Note 2), billings in excess of costs on uncompleted contracts (Note 5), and backlog (Note 7) are disclosures typically made in the financial statements of construction contractors. However, the aging summary of contract receivables is not usually disclosed. In this situation, the preparer concluded that the information is relevant to the financial statement users.
- The information on accounts payable and accruals is not required but has been included because the preparer concluded that users of the financial statements find it meaningful.
- Accounting principles generally accepted in the United States of America (GAAP) requires a summary of future minimum lease payments, which usually is presented in a schedule. Because the entity's lease commitments are not complex, this information has been summarized in narrative form, which is acceptable for financial statements prepared on the tax-basis of accounting.

Charlton Contractors, Inc.
Statements of Assets, Liabilities and Equity
Tax-Basis
December 31, 20X2 and 20X1

	20X2	*20X1*
Assets		
Current Assets		
Cash and cash equivalents	$ 3,078,966	$ 3,608,930
Accounts receivable—contract (Note 2)	2,409,554	1,422,268
Advances to officers	7,812	—
Inventory	287,714	196,200
Total current assets	5,784,046	5,227,398
Property and Equipment		
Machinery and equipment	1,694,980	1,710,828
Transportation equipment	384,790	395,042
Office furniture and equipment	162,454	163,034
Leasehold improvements	363,798	363,798
Total cost	2,606,022	2,632,702
Accumulated depreciation and amortization (Note 3)	(2,362,850)	(2,343,812)
Net property and equipment	243,172	288,890
Other Assets		
Cash surrender value of officers' life insurance	24,454	23,610
Miscellaneous	1,460	20,766
Total other assets	25,914	44,376
Total assets	$ 6,053,132	$ 5,560,664

See accompanying notes to financial statements.

Charlton Contractors, Inc.
Statements of Assets, Liabilities and Equity
Tax-Basis
Years Ended December 31, 20X2 and 20X1
(continued)

	20X2	*20X1*
Liabilities and Stockholders' Equity		
Current Liabilities		
Accounts payable and accruals (Note 4)	$ 548,646	$ 288,904
Billings in excess of costs on uncompleted contracts (Note 5)	976,754	445,108
Total current liabilities	1,525,400	734,012
Contributed Capital		
Common stock, $1,000 par value; 100 shares authorized; 60 shares issued and outstanding	60,000	60,000
Retained Earnings	4,467,732	4,766,652
Total stockholders' equity	4,527,732	4,826,652
Total liabilities and stockholders' equity	$ 6,053,132	$ 5,560,664

See accompanying notes to financial statements.

Charlton Contractors, Inc.
Statements of Operations and Retained Earnings
Tax-Basis
Years Ended December 31, 20X2 and 20X1

	20X2	*20X1*
Contract revenue	$ 7,009,498	$ 8,116,380
Cost of contract revenue		
Direct costs		
Materials and supplies	1,710,330	1,729,310
Salaries and wages	1,184,132	1,264,664
Subcontracts	1,670,596	1,838,942
Other	99,486	92,560
	4,664,544	4,925,476
Indirect costs	813,520	967,278
	5,478,064	5,892,754
Gross profit	1,531,434	2,223,626

	20X2	20X1
General and administrative expenses		
Salaries and wages	1,298,552	2,139,444
Profit-sharing plan contribution	—	6,138
Other	596,938	539,786
	1,895,490	2,685,368
Operating loss	(364,056)	(461,742)
Financing income	88,148	132,590
Net loss	(275,908)	(329,152)
Retained earnings, beginning of year	4,766,652	5,255,804
Distributions to stockholders	(23,012)	(160,000)
Retained earnings, end of year	$ 4,467,732	$ 4,766,652

See accompanying notes to financial statements.

Charlton Contractors, Inc.
Statements of Cash Flows
Tax-Basis
Years Ended December 31, 20X2 and 20X1

	20X2	20X1
Cash flows from operating activities		
Net loss	$ (275,908)	$ (329,152)
Noncash items included in net loss:		
Depreciation	45,718	60,204
(Increase) decrease in:		
Contract receivables	(987,286)	2,103,570
Inventory	(91,514)	(3,260)
Cash surrender of officers' life insurance	(844)	(1,200)
Other assets	—	(408)
Increase (decrease) in:		
Accounts payable and accruals	259,742	(100,832)
Billings in excess of costs on uncompleted contracts	531,646	(895,508)
Net cash (used) provided by operating activities	(518,446)	833,414
Cash flows from investing activities		
Property and equipment purchases	—	(60,000)
Advances to officers	(7,812)	—
Redemption of certificates of deposit	—	2,132,038
Decrease in miscellaneous assets	19,306	—
Net cash provided by investing activities	11,494	2,072,038

(continued)

	20X2	20X1
Cash flows from financing activities		
Distributions to stockholders	(23,012)	(160,000)
Net (decrease) increase in cash and cash equivalents	(529,964)	2,745,452
Cash and cash equivalents, beginning of year	3,608,930	863,478
Cash and cash equivalents, end of year	$ 3,078,966	$ 3,608,930

See accompanying notes to financial statements.

Charlton Contractors, Inc.
Notes to Financial Statements
Tax-Basis
December 31, 20X2 and 20X1

Note 1—Summary of Significant Accounting Policies

Nature of Operations

Charlton Contractors is a general contractor primarily engaged in the construction of commercial and multifamily residential projects in the San Diego metropolitan area.

Basis of Accounting

The accompanying financial statements have been prepared on the accrual method of accounting used for federal income tax purposes, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America (GAAP).

If the accompanying financial statements were prepared in conformity with GAAP, contract revenue and costs would be recognized under the percentage-of-completion method of accounting, an allowance for uncollectible accounts receivable would be established, property and equipment would be depreciated over their estimated useful lives, and the related party lease would be capitalized as an asset and liability.

The Corporation has elected to be treated as a small business corporation (S corporation) under Internal Revenue Code Section 1362. This election provides that, in lieu of corporate income taxes, the taxable items and credits pass directly to the stockholders. Therefore, these financial statements do not include federal or state income taxes that would otherwise be applicable.

The Corporation uses the accrual completed contract method to recognize construction revenue. That method of accounting recognizes contract revenue and costs when a contract is completed or substantially completed. A contract is considered substantially completed when all costs except insignificant items have been incurred and the installation has been accepted by the customer.

Contract costs include all direct material and labor costs and those indirect costs related to contract performance, such as rent, depreciation, maintenance, and insurance. Indirect costs are allocated based on contract revenue. General and administrative costs are charged to expenses as incurred.

Amounts billed in excess of costs are classified as current liabilities under billings in excess of cost on uncompleted contracts. Contract retentions are included in contract receivables.

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Cash and Cash Equivalents
Cash and cash equivalents consist of highly liquid investments with a maturity of three months or less when purchased.

At December 31, 20X2, and 20X1, the Corporation had on deposit with several banks amounts in excess of Federal Deposit Insurance Corporation insurance limits. The Corporation has not experienced any losses in such accounts. The Corporation believes it is not exposed to any significant credit risk on cash and cash equivalents.

Contract Receivables
Contract receivables, including retentions, are recorded as progress billings and rendered in accordance with the provisions of the contracts. The Corporation uses the direct write-off method to record uncollectible accounts in compliance with the Internal Revenue Code.

Inventory
Inventory is valued at the lower of cost, based on the first in, first out method, or market.

Property and Equipment
Property and equipment are recorded at cost and depreciated using principally accelerated methods. Leasehold improvements are amortized over the life of the related leases or their estimated useful lives, whichever is shorter.

Property and equipment are depreciated over the following recovery periods:

Machinery and equipment	5 years
Transportation equipment	5 years
Office furniture and equipment	5–7 years
Leasehold improvements	10–31.5 years

Expenditures for maintenance and repairs that do not materially extend the lives of the assets are charged to earnings. When property or equipment is sold or otherwise disposed of, the cost and related accumulated depreciation are removed from the respective accounts, and the resulting gain or loss is reflected in earnings.

Profit-Sharing Plan
The Corporation adopted a profit-sharing plan effective November 22, 19V4. Substantially all full-time employees are eligible to participate. The Corporation's contributions on behalf of its employees are determined annually by the board of directors. The Corporation did not make a contribution for 20X2. Profit-sharing contributions were $6,138 for the year ended December 31, 20X1.

Statement of Cash Flows
For purposes of the statement of cash flows, cash and cash equivalents include money market accounts and operating bank accounts.

The Corporation did not pay any interest expense for 20X2 and 20X1.

Income Taxes
The Corporation, with the consent of its shareholders, has elected, in accordance with the Internal Revenue Code, to be treated as an S corporation. In lieu of federal income taxes, the shareholders of an S corporation are taxed on their proportionate share of the corporation's taxable income. Therefore, no provision for federal income taxes has been included in these financial statements. California law generally conforms to federal law except for a 1.5 percent tax imposed on S corporation's earnings. The Corporation is subject to tax in other states. Deferred income taxes have not been recognized in these financial statements because the amount of deferred taxes is not considered material.

The Corporation does not recognize a liability for uncertain tax positions until agreement and settlement is reached with the taxing authority. Tax returns filed for the tax years ending from December 31, 20Y9, through current are still subject to examination by federal and state tax authorities.

Subsequent Events

The Corporation has evaluated subsequent events from the date of the statement of assets, liabilities, and equity—tax-basis through March 12, 20X3, the date on which the financial statements were available to be issued, and determined that there are no items to disclose.

Note 2—Contract Receivables

An aging summary of contract receivables at December 31, is as follows:

	20X2	*20X1*
Billed		
Current	$ 1,131,718	$ 364,284
30 days	486,854	306,318
60 days	189,138	79,914
90 days and over	129,326	258,478
	1,937,036	1,008,994
Unbilled retentions	456,512	319,046
Unbilled amounts on completed contracts	16,006	94,228
Totals	$ 2,409,554	$ 1,422,268

Completed and uncompleted contract receivables at December 31, are as follows:

	20X2	*20X1*
Completed contracts		
Billed, including retentions	$ 906,052	$ 706,966
Unbilled retentions	116,772	125,206
Unbilled amounts on completed contracts	16,006	94,228
Uncompleted contracts billed	1,030,984	302,028
Unbilled retentions	339,740	319,046
Totals	$ 2,409,554	$ 1,422,268

Receivables written off as uncollectible totaled $30,158 for the year ended December 31, 20X2, and $2,000 for the year ended December 31, 20X1. Recoveries of receivables written off an uncollectible totaled $17,000 for the year ended December 31, 20X1.

Note 3—Depreciation and Amortization

The accumulated depreciation and amortization balances at December 31, are as follows:

	20X2	*20X1*
Machinery and equipment	$ 1,689,162	$ 1,701,064
Transportation equipment	308,130	296,002
Office furniture and equipment	161,612	160,440
Leasehold improvements	203,946	186,306
Totals	$ 2,362,850	$ 2,343,812

Note 4—Accounts Payable and Accruals

Accounts payable and accruals consist of the following at December 31:

	20X2	*20X1*
Trade accounts payable	$ 343,222	$ 157,726
Subcontract payables	156,130	86,104
Accrued payroll	40,626	39,814
Accrued and withheld payroll taxes	3,124	860
Sales tax payable	5,544	4,400
Totals	$ 548,646	$ 288,904

Note 5—Billings in Excess of Costs on Uncompleted Contracts

Billings in excess of costs on uncompleted contracts at December 31 are as follows:

	20X2	*20X1*
Billings on uncompleted contracts	$ 4,320,008	$ 2,258,286
Costs incurred on uncompleted contracts	(3,343,254)	(1,813,178)
Billings in excess of costs on uncompleted contracts	$ 976,754	$ 445,108

Note 6—Commitment Under Lease Agreement

On December 15, 20V6, the Corporation signed a lease with its stockholders for an office and production facility located in Mira Mesa, California. The facility lease is for 25 years, terminating December 15, 20YY. The base annual rent was $343,000 for 20X2 and

20X1. Increases in the base annual rent are to be based on the consumer price index, not to exceed 6 percent. The stockholders pay the real estate taxes and the Corporation pays all maintenance charges and operating costs for the facility. The rental payments include an escalation for increases in real estate taxes.

At December 31, 20X2, the aggregate minimum lease payments under this lease were approximately $2,800,000. Future minimum lease payments are scheduled to be approximately $350,000 for each of the next 5 years. Rent expense for each of the years ended December 31, 20X2, and 20X1 was $353,000.

Note 7—Backlog

The estimated gross revenue on work to be performed on signed contracts was $3,467,894 at December 31, 20X2, and $4,183,624 at December 31, 20X1. In addition to the backlog of work to be performed, there was gross revenue to be reported in future periods under the accrual completed contract method used by the company of $1,548,173 at December 31, 20X2, and $1,668,961 at December 31, 20X1.

MARGARET ROSE 1964 IRREVOCABLE TRUST FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 20X2 AND 20X1

Circumstances include the following:

- The financial statements are for an irrevocable trust.
- The financial statements are prepared on the cash method of accounting used for federal income tax purposes.
- The financial statements are comparative as of and for the years ended December 31, 20X2, and 20X1.

The financial statements illustrate the following:

- The financial statements do not include a statement of cash flows, which is acceptable for a presentation when applying the tax-basis of accounting. The preparer concluded that a statement of cash flows is not necessary because (1) the users of the financial statements are more interested in asset balances rather than cash flows, and (2) if cash flow information is needed, it could easily be derived from the information presented.

Margaret Rose 1964 Irrevocable Trust
Statements of Assets, Liabilities and Corpus
Tax-Basis
December 31, 20X2 and 20X1

	20X2	*20X1*
Assets		
Marketable securities—at cost	$ 1,830,087	$ 1,560,681
(market value $2,746,922 and $2,353,519 in 20X2 and 20X1, respectively)		
Purchased interest	340	—
Total assets	$ 1,830,427	$ 1,560,681
Liabilities and Corpus		
Due to beneficiary	157,946	75,302
Total liabilities	157,946	75,302
Corpus	1,672,481	1,485,379
Total liabilities and corpus	$ 1,830,427	$ 1,560,681

See accompanying notes.

Margaret Rose 1964 Irrevocable Trust
Statements of Revenues, Expenses and Corpus
Tax-Basis
Years Ended December 31, 20X2 and 20X1

	20X2	*20X1*
Revenues		
Dividends	$ 76,139	$ 69,044
Interest	4,729	4,457
Gain (loss) on sale of securities, net	201,370	46,094
Total revenues	282,238	119,595
Expenses		
Accounting fee	7,500	7,000
Bank custodian fee	3,018	2,588
Investment counsel fee	9,474	7,588
Total expenses	19,992	17,176
Income before provision for income taxes	262,246	102,419
Provision for income taxes	75,144	22,207
Net income	187,102	80,212
Corpus, beginning of year	1,485,379	1,405,167
Corpus, end of year	$ 1,672,481	$ 1,485,379

See notes to financial statements.

Margaret Rose 1964 Irrevocable Trust
Notes to Financial Statements
Tax-Basis
For the Years Ended December 31, 20X2 and 20X1

Note 1—Nature of Trust and Significant Accounting Policies

Nature of Trust
The Margaret Rose 1964 Irrevocable Trust (the Trust) was created on May 5, 1964, by Michael Thomas. Distribution of 25 percent of principal is to be made at age 30, and 33 1/3 percent at age 35. After January 1, 19X2, the beneficiary may request annually a non-cumulative distribution of the larger of $5,000 or 5 percent of the principal as of the end of the year. Upon death of the beneficiary, the Trust is to be distributed according to the terms of her will. The trustee has discretionary power to distribute principal or income, or both.

Basis of Accounting
The accompanying financial statements have been prepared on the cash method of accounting used for federal income tax purposes, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America (GAAP). Consequently, certain revenues and expenses are recognized in the determination of income in different reporting periods than they would be if the financial statements were prepared in conformity with GAAP. Although income tax rules are used to determine the timing of the reporting of revenues and expenses, nontaxable revenues and nondeductible expenses are included in the determination of net income.

Use of Estimates
The preparation of financial statements in conformity with the cash method of accounting used for federal income tax purposes requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Marketable Securities
Marketable securities are carried at cost. The cost of marketable securities sold is based on cost as determined under the specific identification method.

Income Taxes
The Trust does not recognize a liability for uncertain tax positions. Tax returns filed for the tax years ending from December 31, 20Y9, through current are still subject to examination by federal and state tax authorities.

Subsequent Events
In preparing these financial statements, the Trust has evaluated events and transactions for potential recognition or disclosure through April 1, 20X3, the date the financial statements were available to be issued, and determined that there are no items to disclose.

Note 2—Marketable Securities

At December 31, 20X2, and 20X1, gross unrealized gains and losses pertaining to marketable securities in the portfolio were as follows:

	Cost	*Market Value*	*Unrealized Gains*	*Losses*
20X2				
Equities	$ 948,766	$ 1,790,955	$ 854,565	$ 12,376
Fixed income and money market	881,321	955,967	119,362	44,716
Total	$ 1,830,087	$ 2,746,922	$ 973,927	$ 57,092

	Cost	*Market Value*	*Unrealized Gains*	*Losses*
20X1				
Equities	$ 891,685	$ 1,611,732	$ 757,910	$ 37,863
Fixed income and money market	668,996	741,787	72,791	—
Total	$ 1,560,681	$ 2,353,519	$ 830,701	$ 37,863

Note 3—Income Taxes

The income tax expense shown in the accompanying financial statements differs from the expense that would result from applying statutory tax rates to income before income taxes primarily because of capital gains. Distributions to beneficiaries are allowed as a deduction from taxable income for the trust in the year in which such distributions are made.

The provision for income taxes for the years ended December 31 consists of:

	20X2	*20X1*
Federal	$ 63,200	$ 17,874
State	11,944	4,333
Provision for income taxes	$ 75,144	$ 22,207

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