

TAX ACCOUNTING GUIDELINES FOR SMALL BUSINESS[©]

(TAGSB)



**National Society of Accountants
1010 N. Fairfax Street
Alexandria, VA 22314-1574
800-966-6679
www.nsacct.org**



Tax Accounting Guidelines for Small Business[©] (TAGSB)

**Version 2.01
July 2006**

**Presented by the
Accounting Standards Committee
of the
Right to Practice Committee**

Copyright © 2004, 2005, 2006 by the National Society of Accountants. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of the National Society of Accountants.

FOREWORD

Institutions of higher learning in the United States teach Generally Accepted Accounting Principles (GAAP) as the “generic” brand of accounting for use by businesses in creating their financial statements. Licensees of state boards of accounting are required to use GAAP in most instances. However, the regulatory burden of complying with GAAP can be very high and this burden has been a concern of the accounting community for quite some time. For large businesses, such regulatory burden is probably necessary, but for most small businesses the cost of preparing GAAP-based financial statements is excessive and in many cases unnecessary.

Many small businesses maintain their books and records on the same basis needed to report income and deductions on their annual income tax returns to the Internal Revenue Service. Translating tax return information into a financial statement format can be a cost effective strategy. Preparation of financial statements using the Tax Accounting Guidelines for Small Business (TAGSB) contained herein constitutes voluntary compliance with the tax accounting principles, prohibitions and restrictions contained in the Internal Revenue Code (IRC), and the requirements for prudence and diligence in Treasury Department Circular No. 230. Because the penalties for failure to comply with the nation’s tax laws can be severe, individuals who rely on the tax basis of accounting generally have an additional level of confidence concerning the resulting statements.

Financial statements prepared using these Guidelines merge the best attributes of conventional classifications and tax return formats. The traditional balance sheet format classifies assets into three distinct categories: current, fixed and other. The tax return format does not use these categories but simply groups accounts into specific general accounts. TAGSB allows the integration of the tax return presentation into the “traditional” presentation in a unique, easy to read and understandable format.

ACKNOWLEDGMENTS

The NSA Board of Governors wishes to express its deep appreciation to the members of the successive Accounting Standards Committees who worked diligently on this project during their terms. Without their continuing efforts, the Tax Accounting Guidelines for Small Business (TAGSB) could not have been successfully developed.

Terry M. Bayless Sr., CPA, ABA
Betty Jo Berryman, LPA, ABA
Milton Brown, PA, EA, ABA, ATA, ATP
Eldon R. Clingan, EA, ABA, ATA, ATP
Donald L. Cordano, EA, ABA, ATA, ATP
Robert L. Cross, PA, ABA, ATA
Gale H. Dalton-Champie, ABA, ATA
Richard N. Davis, ABA
Roy Frick, LPA, EA, ABA, ATA, ECS
Alfred C. Giovetti, CPA, ABA, ATA
Christine C. Giovetti, CPA, EA, ABA, ATA
Wanda W. Goodson, CPA, ABA, ATA
Felix Guillot, Jr., EA, ABA, ATA
Robert J. Holden, RPA, EA
David L. Hooker, EA, ABA, ATA, ATP
Lillian R. Lea, EA, ABA, ATA
David E. Loy, LPA, EA, ABA
J. Michael Moye, EA, ATP
James H. Nolen, EA, ABA, ATA, ATP
George M. Parker, EA, ATA
Gary C. Rohrs, EA, ABA, ATA
Wanda L. Samek, EA, ABA, ATA, ATP, ECS
John W. Schabow, ABA, ATA, ATP
Barbara A. Stechnij, EA, ABA, ATA, ATP, ECS
Norma Nick Taylor, EA, ABA, ATA, ECS
Frank C. Santos, Jr., CPA, EA, ATA
Daniel E. Setters, EA, ABA, ATA, ATP, ECS
R. Deane Wymer, ATP

We also are grateful to the practitioners who responded to our invitation for comments on the preview draft presented at the September 2004 National Accounting and Tax Symposium. Your contributions assisted in improving the document.

The Board of Governors wishes to give special recognition to James H. Nolen and Lillian R. Lea for their commitment to completion of the TAGSB project.

TABLE OF CONTENTS

Section 1	Purpose, Definitions and General Principles.....	1
100.00	General.....	1
101.00	Definitions.....	2
102.00	General Principles.....	5
103.00	Level of Knowledge.....	5
104.00	Accountant Not Independent.....	5
105.00	Accountant’s Level of Care.....	6
Section 2	Tax Accounting Principles and Procedures.....	7
200.00	General.....	7
201.00	Method of Accounting.....	7
202.00	Accounting Records.....	8
203.00	Change in Accounting Method.....	8
204.00	Accounting Periods.....	9
205.00	Financial Statement Preparation.....	10
Section 3	Reporting.....	25
300.00	Engagement Letter.....	25
301.00	The Accountant’s (Preparer’s) Report.....	25
302.00	Accountant’s Report – General Language.....	26
303.00	Tax Basis Financial Statements – Year-End.....	26
304.00	Exception to Full Disclosure.....	26
305.00	Financial Statements – Required Comment.....	27
306.00	Format of Financial Statements.....	27
307.00	Notes to the Financial Statements and Other Attachments.....	27
308.00	Interim Financial Statements.....	28
309.00	Internal Use Only Statements.....	29
310.00	Reading of the Financial Statements.....	30
Appendices.....		31
Appendix A	Notes and Disclosures.....	32
Appendix B	Engagement Letter.....	33
Appendix C	Full Disclosure Checklist (Long Form).....	34
Appendix D	Financial Statement Checklist (Short Form).....	45
Appendix E	Accountant’s Report Checklist (Short Form).....	46
Appendix F	Sample Accrual Basis Financial Statements – Full Disclosure.....	48
Appendix G	Sample Cash Basis Financial Statements – No Disclosure.....	58
Appendix H	Additional Recommended Reference Materials.....	62

TAGSB – Section 1 Purpose, Definitions and General Principles

100.00 General

100.01 Purpose

Tax Accounting Guidelines for Small Business (TAGSB) are designed to provide guidance to accountants for the preparation of financial statements presented in conformity with the principles of accounting used in the preparation of tax returns. These Guidelines have been established on the basis of the Internal Revenue Code. Individuals who do not hold a license or permit to practice accountancy issued by a state board of accountancy or similar regulatory entity may use these Guidelines. Use of these Guidelines by licensed accountants may be restricted by applicable state law.

The tax basis of accounting provides an alternative method of accounting to meet the needs of small business. In contrast to financial statements based on generally accepted accounting principles (GAAP), it requires the entity to maintain only one set of financial records – those required for the preparation of the Federal tax return. See Section 101.21 for the Internal Revenue Service definition of small business.

These Guidelines are consistent with the Code of Ethics and Rules of Professional Conduct of the National Society of Accountants (NSA) and assume that the accountant will comply with Treasury Department Circular 230, whether or not required to do so.

Upon written request, NSA will endeavor to answer questions regarding specific interpretations of the Guidelines, and every effort will be made to assist the users. However, NSA will not provide legal advice with regard to the interpretation of tax laws and/or state and local accountancy statutes and regulations. Also, NSA will not provide legal or other advice on the application of these Guidelines to any specific situation. The accountant must use professional judgment whether the Guidelines provided here are applicable to any other services to be provided. These Guidelines may not be applicable in all jurisdictions.

Before preparing an accountant's report or financial statements (with or without notes) based on these Guidelines, users of these Guidelines should always consult all appropriate authorities to ascertain the restrictions imposed by their particular local law that might apply to the use of these Guidelines. Differences between local laws may vary widely from jurisdiction to jurisdiction and any examples contained herein are always subject to modification when in conflict with local law.

100.02 Guideline Maintenance

In order to maintain these Guidelines as a useful resource for accountants, the NSA Accounting Standards Committee will meet from time to time to consider requests for interpretation or clarification of these Guidelines. The Committee will issue interpretations as it deems necessary and make revisions to the Guidelines as appropriate.

101.00 Definitions

The following definitions apply to these Guidelines.

101.01 Accountant

The term “accountant,” when used in these Guidelines, refers not only to the licensee of a Board of Accountancy but also to individuals who do not hold a license or permit issued by a state Board of Accountancy or other similar regulatory entity. In these Guidelines, the term “accountant” is interchangeable with the word “preparer.”

101.02 Accountant’s (Preparer’s) Report

The “accountant’s report” is a communication from the accountant to the owner, partners, shareholders or other principals of the accounting entity and states the date of the accountant’s report, the scope of work involved and the limitations of assurance, if any, that the accountant is making in the engagement. For the purposes of these Guidelines, the terms “Accountant’s Report” and “Preparer’s Report” are interchangeable. The accountant’s report should be presented on firm letterhead or comparable format. If this presentation of information is not permitted by local law to be in the accountant’s report, the above items would be presented in the notes to the financial statement.

101.03 Balance Sheet – Income Tax Basis

This term has the same meaning as the term “Balance Sheet” on a Federal tax return. The term encompasses “Statement of Assets, Liabilities, and Equity,” and such other terminology that is conventionally understood to include an accounting of assets, liabilities and equities. In some jurisdictions, local law may require the use of alternate terminology. This document will generally use the term “Balance Sheet.”

101.04 Book Income

This is the net profit (or loss) computed for the entity for which the financial statements are being prepared. It may not necessarily agree with taxable income because it may include non-taxable revenue, non-deductible expenditures and other items. It is the objective for which the accounting under TAGSB is performed. It has the same meaning, and definition as is used in Internal Revenue Service publications. The Internal Revenue Code may define items as income or expense that are not actually recognized as such in determining taxable income.

101.05 Capital - See Equity at 101.11.

101.06 Checklists

For these Guidelines, the word “checklist” means a list of items consolidated from these Guidelines and outside sources to assist the accountant. Checklists are normally not meant to be all-inclusive. Therefore, the use of the checklists herein does not permit the accountant a defense against omission of material items. The accountant should always apply due diligence and the realistic possibility standard as defined in Circular 230, sections 10.22 and 10.34, respectively, in the preparation and or presentation of information under these Guidelines.

101.07 Compilation

For purposes of these Guidelines, the terms “compilation” and “preparation” are interchangeable. However, in many jurisdictions local law places certain restrictions on the use of the term “compilation,” and the accountant must follow the local law requirements.

101.08 Disclosures

“Disclosures” are information included in a financial statement presentation to enable the reader to better understand the statements. They can be found in the notes to the financial statements or, on a limited basis, in the accountant’s report or both. Also see Notes to the Financial Statements at 101.19.

101.09 Engagement Letter

An “engagement letter” is a contract between the client and the accountant covering the scope of the engagement.

101.10 Entity

The term “entity” includes proprietorships, partnerships, corporations, limited liability companies (LLCs), limited liability partnerships (LLPs), not-for-profit organizations, or any other entity recognized by the Internal Revenue Service.

101.11 Equity

Simply defined, assets minus liabilities equal “equity.” Equity, in some instances referred to as capital, represents the accumulated contributions of capital into the entity, reduced by capital returned by the entity, combined with the accumulated income or losses of the entity. In these Guidelines, equity is a global, all-inclusive term, while capital is used to refer to equity accounts that can or must be traced to specific members, partners or shareholders.

101.12 Financial Statement

A “financial statement” is a presentation of financial data, which may or may not include accompanying notes, derived from accounting records and intended to communicate an entity’s economic resources and obligations at a point in time, or the changes therein for a period of time.

101.13 Firm

For the purposes of these Guidelines, the term “firm” means any legal form of business allowed within a given jurisdiction to prepare financial statements and/or Federal income tax returns.

101.14 Imputed Interest

“Imputed interest” is the interest required by the Internal Revenue Code to be calculated in certain instances of non-interest or below market rate loans.

101.15 Income Reconciliation Statement

The “income reconciliation statement” is a statement that reconciles book net income per the financial statements with taxable income per the entity’s tax return. This statement provides the explanation of any variances between the taxable income or loss on the tax return and the

net income or loss on the financial statements. It is normally included for a complete presentation of financial statements prepared using these Guidelines.

101.16 Interim Statements

“Interim statements” are any statements issued for a period of less than a complete tax year.

101.17 Internal Revenue Code (IRC)

The Internal Revenue Code is Title 26, United States Code. An understanding of the Internal Revenue Code includes familiarity with the Internal Revenue Code, the Internal Revenue Regulations, Revenue Rulings, Revenue Procedures, Notices from the Commissioner, and applicable court decisions.

101.18 Local Laws

When used in these Guidelines, “local laws” refers to the accumulated restrictions and requirements placed on practitioners from all of the following sources: state and local laws, including but not limited to accountancy statutes; state Board of Accountancy rules, regulations and interpretations; and judicial precedents.

When these Guidelines are in conflict with any of these sources of authority, the practitioner must alter TAGSB to fit those circumstances. For example, if use of the word “compiled” is prohibited by state law but use of the word “assembled” is permitted, the practitioner simply substitutes “assembled” for “compiled” in his/her report language. No additional paragraph, note or any other reference is needed under these circumstances to highlight or point out this departure from TAGSB.

101.19 Notes to the Financial Statements

The “notes to the financial statements” are part of a complete financial statement presentation. When a reference is made in these Guidelines to ‘notes,’ it will always be intended that the ‘note’ will be placed in the Notes to the Financial Statements section of the presentation unless a specific reference is made to placing the ‘note’ elsewhere.

In those jurisdictions with restrictions on the content of the accountant’s report, any item suggested by these Guidelines to be included in the accountant’s report but cannot be placed there because of local law, would be included in the notes to the financial statements. If local law prohibits the use of notes to the financial statements, but does allow the use of the accountant’s report or its equivalent, then those items that would otherwise have been reported in the notes to the financial statements would be reported in the accountant’s report.

101.20 Presentation of Financial Statements

Financial statements are prepared using the same tax accounting principles used to prepare the Federal tax return. Book income (defined at 101.04) may vary from taxable income.

101.21 Small Business

The Internal Revenue Service generally defines small businesses as those having assets under \$10 million. For the purposes of these Guidelines, this general group of businesses is what is referred to as “small business.” This is not to say that a business with assets greater than \$10

million may not use these Guidelines; quite the contrary is true. They are designed for use by all businesses that are not publicly traded.

101.22 Statement of Cash Flows – Income Tax Basis

The Statement of Cash Flows – Income Tax Basis presents information that shows how net profit on the Statement of Revenues and Expenses – Income Tax Basis relates to the change in cash and cash equivalents. It shows the relationship of beginning and ending cash and cash equivalents that appear on the balance sheet. This statement is normally included for a complete year-end financial statement presentation.

101.23 Statement of Revenues and Expenses – Income Tax Basis

This statement encompasses profit and loss and such other terminology that is conventionally understood to imply an accounting of revenues and expenses. In some jurisdictions local law may require the use of alternate terminology. These Guidelines generally use the title “Statement of Revenues and Expenses – Income Tax Basis.”

101.24 Tax Accounting Principles

These principles are those that are promulgated and set forth in the whole body of tax law, plus those that are conventionally understood as having application thereto.

102.00 General Principles

These Guidelines are intended to provide assistance in the preparation of financial statements utilizing the tax basis method of accounting. Financial statements prepared using these Guidelines have the following unique characteristics:

1. Use of the Income Reconciliation Statement.
2. Use of the Statement of Cash Flows – Income Tax Basis.
3. Flexibility as to financial statement titles.

The use of these Guidelines presumes that the preparers of financial statements use double-entry accounting in all cases, regardless of the type of entity or method of accounting.

103.00 Level of Knowledge

The following minimum level of knowledge should be attained in order for the accountant to prepare financial statements.

103.01 Knowledge of the Industry

The accountant should, at a minimum, have a general knowledge of the client’s industry for which the financial statements are to be prepared. Absent this knowledge, the accountant should either acquire the knowledge, or seek the advice of other accountants who are knowledgeable about the industry. The accountant should endeavor to become familiar with the industry for any engagement through continuing professional education classes, experience gleaned from prior engagements or technical resources.

103.02 Knowledge of the Client

The accountant should, at a minimum, have a general knowledge of:

1. The nature of the entity's business transactions including the source and nature of revenues and expenditures.
2. The form and content of the entity's accounting records.
3. Knowledge of the tax accounting principles related to the industry.

104.00 Accountant Not Independent

When the accountant is not independent with respect to the engagement, this should be disclosed in the last paragraph of the accountant's report.

105.00 Accountant's Level of Care

Accountants should adhere to the Code of Ethics and Rules of Professional Conduct of the National Society of Accountants (www.nsacct.org) or other recognized professional standards and perform their duties in the highest ethical manner. Accountants should refer to the Internal Revenue Code and to Treasury Department Circular No. 230 (www.irs.gov) for additional guidance with regard to prudence, due diligence, the realistic possibility standard, and the "prudent person" rule. It is recommended that the user be familiar with Sections 10.22 (Diligence as to Accuracy) and 10.34(a) (Realistic Possibility Standard) of Circular 230.

For all entities, the accountant should make inquiries of management to determine major policy positions or decisions of the entity. Such inquiries include, but are not limited to:

1. For a corporation this would include receiving copies of the articles of incorporation, corporate charter and bylaws, as well as minutes of all stockholder and director meetings. Also, the accountant should, at a minimum, receive the prior year's tax return to be adequately informed about the entity.
2. Similar documents for partnerships, LLCs and LLPs should be reviewed. If the entity is an S-corporation, a copy of the "S" election should be obtained for the accountant's file.
3. In the case of an LLC, the election as to tax treatment selected should be obtained.
4. In the case of a new client, the accountant should obtain and review copies of all prior minutes and tax returns for the three previous years.
5. All of the above referenced documents should be kept in the accountant's permanent file on the client and updated annually.
6. If the accountant is not allowed to review the prior year records or they no longer exist, this omission of information that should have been available to the accountant should be included in the notes to the financial statements, if included as part of the presentation.

The accountant should review with the client, periodically during the year and again at year-end, both general concepts of classifying income and expense data and specific decisions regarding special elections that are optional in the IRC. The accountant should document these meetings and decisions made at these meetings in some permanent manner in the client's file or records.

TAGSB – Section 2 Tax Accounting Principles and Procedures

200.00 General

These Guidelines presume that the financial statements are consistent with the tax return. If there are deviations, they should be disclosed in one of the following (listed in order of preference):

1. Notes to the Financial Statements (when prepared), or
2. Income Reconciliation Statement, or
3. Accountant's Report.

Items such as carryovers and tax credits should not be shown on the financial statements but should be shown in the notes to the financial statements, if included in the presentation.

201.00 Method of Accounting IRC 445, 446, 447, 448, 451, 453, 481 and others.

Taxable income should be computed either under the method of accounting used on the tax return or under the exceptions allowed for in the IRC and regulations.

The tax law recognizes that no uniform method of accounting can be prescribed for all businesses. Often, the accountant will assist management in adopting a method of accounting best suited for the particular business. The method chosen must clearly show income and expenses and the same method must be used each year unless a change is mandated by the IRC. There are four principal methods of tax accounting:

1. Cash method.
2. Accrual method.
3. Special methods of accounting for certain items of income and expense.
4. Hybrid method.

The method of accounting should be disclosed in the report, preferably, but may be disclosed in the notes to the financial statements.

Generally, the cash method recognizes income when cash is received and expenses when they are paid. The accrual method recognizes income when it is earned, whether or not received, and recognizes expenses when they are incurred, whether or not they are paid within the accounting period. There are other methods of accounting in the IRC, such as the installment method, the long-term contract method, the special farm-hybrid method, and other such methods as may be prescribed. Uniform capitalization rules require the capitalization of certain costs for production or resale activities, no matter what accounting method is used.

201.01 Cash Method IRC 446, 451

Under the cash basis of accounting, income includes all income that was actually or constructively received during the year, either in cash and cash equivalents or in other forms, such as property or services. Property and services must be recorded as received at fair market value. Expenses include all disbursements made during the year in cash and cash equivalents or certain other property. The disbursement must be ordinary, necessary, reasonable and related, and specified within the various sections of the IRC.

Certain expenditures may be required to be capitalized or deferred even though actually paid during the period.

Certain entities are excluded from using the cash method of accounting by the IRC.

201.02 Accrual Method IRC 446, 451

Under the accrual method, income and expenses are included for the taxable year when all the events have occurred that fix the right to receive the income or to deduct the expense. The accrual method is generally considered to be a more accurate representation of business activity because the purpose of the method is to match income and expenses in the period incurred. The basic rules of the accrual method of accounting are:

1. The right to receive income determines its inclusion in gross income.
2. An expense is accrued when actual liability is incurred except when in conflict with the IRC.
3. The accrual basis should be used when inventory is present, unless IRC rulings or regulations allow an exception.

Certain entities are required by the IRC to use the accrual method of accounting.

201.03 Special Methods IRC 61, 446, 453, 460, 461, 471

The IRC provides special methods for accounting for certain items of income and expense, such as installment sales, long-term contracts, and farm crops and inventories.

201.04 Hybrid Methods IRC 446

The hybrid method is defined as any combination of cash, accrual or special methods of accounting. The combination must clearly show income and must be used consistently. The IRC puts certain restrictions on the use of the hybrid method.

202.00 Accounting Records IRC 446

The IRC requires all entities to maintain adequate accounting records in order to properly characterize income and expenses and to accurately determine taxable income. These Guidelines presume the use of double-entry accounting for all types of entities.

203.00 Change In Accounting Method IRC 446, 481

Generally, entities that change their method of accounting must obtain consent from the Commissioner of Internal Revenue before computing their income under the new method, even if the new method is proper and permitted by the IRC. A change in the method of accounting includes a change in the overall method of accounting for items of gross income or expenses, as well as a change in the treatment of any material item that affects the timing of the inclusion of that item in income or expense. Whenever a change in accounting method has occurred, and comparative financial statements are part of the presentation, the prior year amounts are restated using the new accounting method only when an amended tax return for that period has been filed. When the prior year amounts are not changed to reflect the new accounting method,

include a note to disclose that the prior year amounts are based on a different accounting method and have not been changed.

When the accounting method is changed either because the entity requests the change or the Internal Revenue Service requires the change, net income must be computed using both the new and old methods and an adjustment must be made to correct for this variance. The IRC provides for the time allowed for the adjustment. Such items should be disclosed in the notes to the financial statements, if included in the presentation. If notes to the financial statements are not prepared, this change would be noted in the accountant's report.

Caution: The accountant must be familiar with the most recent Revenue Procedures that apply to any change in accounting method.

203.01 Types of Accounting Changes

Accounting changes may include, but are not limited to:

1. Change from the cash to an accrual method, or vice versa.
2. Change from the cash or accrual method to a long-term contract method.
3. Change in the method or basis used in valuing inventory.
4. Change in the method of figuring depreciation, unless specifically permitted.
5. Change in other material items of income or expense.

203.02 Change in Method of Accounting Does Not Include:

1. Adjustment of income or expense items that do not involve proper timing.
2. Correction of errors involving the computation of tax.
3. Correction of mathematical or posting errors.
4. An adjustment in the useful life of a depreciable asset.

204.00 Accounting Periods IRC 441, 442, 443, 444

Taxable income is computed on the basis of an entity's annual accounting period, which may be a calendar year, fiscal year, or a 52-53 week year.

A fiscal year means an accounting period of twelve months ending on the last day of any month other than December. A calendar year is an accounting period of twelve months ending on December 31. An entity that regularly keeps its books on the basis of a period varying from 52 to 53 weeks may end its fiscal year on the day of the week which occurs for the last time in the calendar month, or which falls nearest to the end of the calendar month.

Within certain limitations set forth in the IRC, a new entity is free to adopt the calendar year or a fiscal year of its choice, thus creating a one-time only short year.

To change an accounting period, approval must be received from the Commissioner of Internal Revenue, unless exempted by the IRC. The financial statements must reflect the short period of time between the ending of the old accounting period and the beginning of the new accounting period.

205.00 Financial Statement Preparation

205.01 Preparation of Balance Sheet – Income Tax Basis

The balance sheet is prepared to indicate the financial position of the entity as of the last day of the reporting period, and the heading must include that actual date.

205.01(a) Assets

Assets should be classified as current, fixed, and other.

205.01(a)(1) Current Assets

Current assets of the business include cash, inventories, receivables, and any asset that will be converted into cash within one year. Current assets are generally presented in order of liquidity on the balance sheet.

205.01(a)(2) Cash and Cash Equivalents IRC 446, 451

The notes to the financial statements (if included in the presentation) should contain a definition of cash and cash equivalents unless the account name is totally descriptive of the makeup of the account and the account is located in the United States.

The accountant should ask the client for the cash and cash equivalents balances. Also, the accountant should determine if any items that would normally be included in current assets should be included instead in other assets because of restrictions on use or for any other reason, and, if so, should include an explanation in the notes to the financial statements, if part of the presentation.

205.01(a)(3) Trade Notes and Accounts Receivable IRC 446, 451

The accountant should ask the client for the accounts receivable balance and any trade notes receivable unless on the cash basis.

205.1(a)(4) Bad Debts IRC 166

An adjustment to the accounts receivable account should be made for those individual accounts that have been determined to be uncollectible. This adjustment is based on the direct write-off method. The collectability of an account should be determined objectively.

205.01(a)(5) Inventories IRC 263A, 471, 472, 473, 474, 475

205.01(a)(5)(i) Definition

Inventories are goods on hand that are held primarily for sale by the entity in the normal course of operations. For retail operations there is only one class of inventory, (i.e., items held for sale). However, for manufacturing operations there can be three classes of inventory:

1. Raw Materials.
2. Work-in-Process.
3. Finished Goods.

Under certain conditions it may be appropriate not to use all three classes, provided that operations support that particular method.

In certain cases, supplies that physically become a part of the item intended for resale must also be included in inventory.

205.01(a)(5)(ii) Recognition

Under appropriate tax accounting methods, it is necessary that the financial statements present the correct inventory balance at the close of the accounting period. Inventory sold during the accounting period should be included in the cost of goods sold. Ending inventory should be capitalized and transferred to the subsequent accounting period, to be matched at that time against the sale. The accountant should receive the ending inventory balance(s) from the client. The methods of identification and valuation must be used consistently from year to year. If including notes to the financial statements, the methods of identification and valuation should be disclosed.

205.01(a)(5)(iii) Identification

A specific method of identifying the ending inventory must be chosen and periodically, a physical inventory must be taken. Either a perpetual or book inventory may be used to calculate inventory under these Guidelines. The preferred method of identification of inventory is to match actual cost with each specific item. If that cannot be done, the following methods are acceptable:

1. First-in first-out (FIFO).
2. Last-in first-out (LIFO).
 - (a) Dollar-value.
 - (b) Simplified dollar-value.
3. Any other method allowed or required by the IRC.

205.01(a)(5)(iv) Valuation

All methods allowed by the IRC are usable for tax accounting financial statement presentations. The following methods are acceptable:

1. Cost.
2. Lower of cost or market.
3. Retail.
4. Any other method allowed or required by the IRC.

The accountant should determine if the client is also required to apply the Uniform Capitalization method to inventory valuation.

205.01(a)(6) U. S. Government Obligations

These are debt instruments issued by the Federal government and certain agencies of the Federal government. They will usually be current assets because of their relative liquidity, but use professional judgment when classifying to insure proper placement.

205.01(a)(7) Tax-Exempt Securities

These are other debt instruments issued by state, local and other tax-exempt entities whose interest is excludable from gross income under section 103(2) of the IRC. The accountant should verify that the income stream from the instrument is truly tax-exempt; otherwise, the security should not be placed in this category. Also included here would be investments in funds that pool assets to invest jointly in government securities, such as mutual funds. Use professional judgment when classifying to insure proper placement.

205.01(a)(8) Other Current Assets and Prepaid Items IRC 263, 263A, 455, 456, 457, 458, 461

When an expenditure is made for the purchase or creation of an asset having a useful life of more than one year, or is for an expense when economic performance has not occurred, the expenditure cannot be deducted in the current year. This treatment applies to both the cash and accrual methods of accounting. When using the cash method, if the IRC requires the deferral of an expense, the proper method would be to show the deferred expense on the balance sheet as a prepaid expense. If the expense is shown on the statement of revenues and expenses and therefore reduces retained earnings, this should be disclosed in the notes to the financial statements, if part of the presentation.

205.01(a)(9) Loans to Shareholders

Loans to shareholders are classified separately for income tax reporting purposes. When classifying loans to shareholders, the accountant should carefully consider whether there is written proof as to the debt and the repayment history of the debt. The proper classification of the account(s) should be based on its history as to whether it is classified as a current or other asset. Also, if there is no evidence of the debt, consideration should be given to reclassifying the payment(s) as wages or a dividend. The accountant should determine whether a disclosure in the notes to the financial statements (if presented) is warranted. Loans to shareholders may be presented in a separate section on the financial statements rather than being classified as either a current or other asset.

205.01(a)(10) Mortgage and Real Estate Loans

Mortgage and real estate loans receivable are classified separately for income tax reporting purposes. They can be classified as either current or other assets on the balance sheet. However, it is not recommended to reclassify the current portion of a single mortgage or loan as a current asset and then classify the remaining balance as an other asset. Mortgage and real estate loans may also be presented as a separate section on the financial statements rather than being classified in either current or other assets.

205.01(a)(11) Other Investments

Any form of investment not yet classified in these Guidelines, such as securities, investments or loans to other companies, would be considered other investments if not deemed to be a current asset.

205.01(a)(12) Fixed Assets

The accountant should ask for a list of assets placed in service during the year, and should book any assets placed in service but not yet paid for, even under the cash method. Suitable inquiries should also be made regarding assets acquired in prior years that may have been sold, destroyed or otherwise disposed of.

205.01(a)(12)(i) Buildings and Other Depreciable Assets IRC 263, 1012, 1031, 1033, 1221

When an expenditure is made for the purchase or improvement of an asset that is subject to depreciation, amortization or depletion under the IRC, the expenditure should be capitalized and is considered to be the cost basis of the asset.

The accountant should determine the basis of the assets in accordance with the appropriate sections of the IRC. Any material amount of a normally depreciable item that is not depreciable for tax purposes, such as the portion of the purchase price of replacement property that represents the untaxed gain from a Section 1031 exchange, should be disclosed in the notes to the financial statements, if they are part of the presentation.

205.01(a)(12)(ii) Depreciation (Cost Recovery) IRC 167, 168, 179

Depreciation is an expense that spreads the deduction for the cost of an asset over a period of time prescribed by the IRC. Before 1981, the period of time was determined by the useful life of the asset. After 1980, the period of time was set by statute.

When making notes regarding depreciation, the accountant needs to take into account only assets that are still generating depreciation expense in the current period (including section 179 expense, special depreciation allowances and bonus depreciation) and when that amount is material to net income. Notes (when presented with the financial statements) should disclose the method(s) used to calculate the depreciation.

205.01(a)(12)(iii) Depletable Assets (Natural Resources)

In general, natural resources are those long-term assets attributable to items found in nature. Mining properties, oil and gas reserves, and standing timber are examples of natural resources. Natural resources are distinguished from other tangible and intangible property in that they are physically removed from the natural environment and converted to inventory.

205.01(a)(12)(iv) Depletion IRC 57, 611, 612, 613, 167, 642, 636

Applicable sections of the IRC determine over what periods depletion is applied to natural resources. Depletion is the rate at which these items are expensed as they are taken out of or off the ground. Buildings and equipment that are closely related to the natural resources may be depreciated at a rate similar to the natural resources, based upon the natural life of the asset or the life of the natural resource, whichever is shorter.

205.01(a)(12)(v) Land IRC 162, 182, 263, 460, 595, 732, 1012
The basis of land is determined in accordance with the IRC.

205.01(a)(13) Intangible Assets IRC 197

Intangible assets are inanimate in nature and generally do not have a high degree of certainty with regard to their future worth or benefit. Examples of some common intangible assets are patents, copyrights, goodwill, and covenants not to compete. Most intangible assets may be amortized over a period of time determined by the IRC.

205.01(a)(14) Amortization IRC 75, 169, 171, 178, 190, 194, 195, 197, 248

To the extent that intangible assets have a determinable life, their cost, or other basis, is amortized using a straight-line method applied over the accounting periods affected by that asset, as allowed by the IRC. Not all intangible assets can be amortized. Self-created intangibles such as an interest in a partnership or a sports franchise may not, under the IRC, be amortized. See IRC section 197 for more information on intangible assets and the applicability of amortizing specific intangibles.

205.01(a)(15) Other Assets IRC 263, 264, 197

The other assets section contains those assets that are considered neither current assets nor fixed assets. Examples of these are utility deposits, last month's rent in advance and sales tax deposits.

Other assets, which do not have a determinable life, are maintained in the accounting records until the subsequent disposition of the asset, or expensed in the current period if allowed by the IRC.

205.01(a)(15)(i) Deferred Expenses/Losses IRC 461, 464, 469

Certain sections of the IRC require deferral of recognition of certain deductions and losses. Examples of these are expenditures that fail the economic performance test and that do not fall under prepaid expenses, and losses that are not currently recognized, such as suspended passive losses. If notes to the financial statements are included, these accounts should be disclosed.

205.01(b) Liabilities

Liabilities should be classified into current, long-term, and other categories. The accountant should ask the client for the balances of all liabilities as of the end of the period, and should determine the classification with the assistance of management.

When the IRC allows booking an asset acquisition or expense before an expenditure has been made and the cash method is being used, the preferred method is to show the item on the balance sheet as a liability. However, it may be shown in equity if this is disclosed in the notes to the financial statements, if they are part of the presentation.

205.01(b)(1) Current Liabilities

A current liability is an obligation that becomes due within one year and requires the use of current assets or the creation of new current liabilities. When on the accrual basis, current liabilities include, but are not limited to, accounts payable, notes payable, current portion of long-term debt and dividends payable.

If the entity chooses not to show the breakdown of the short-term portion of the long-term debt, then a disclosure would be presented on this deviation in either the accountant's report or in the notes (if prepared).

205.01(b)(1)(i) Accounts Payable IRC 446

Accounts payable are generally understood to represent amounts owed to a creditor, usually on account, for the purchases of goods, supplies, and services. Accounts payable can be distinguished from other current liabilities because accounts payable are incurred for commodities and services arising out of everyday transactions.

205.01(b)(1)(ii) Mortgages, Notes, Bonds Payable in Less Than One Year IRC 446

Mortgages, notes, and bonds payable are reported separately for income tax reporting purposes. When on the accrual basis, the portion of bonds, mortgage notes, and other long-term indebtedness that matures within the next year should be reported in current liabilities, or as a separate section on the financial statements. The remaining portion of the debt is reported as a long-term debt. Loans from owners, shareholders, or members are reported as a separate category.

The accountant should retain in the work paper file the computation of the short-term portion of long-term indebtedness and other available documentation of the items that appear on the balance sheet.

If notes to the financial statements are included, the collateralization of the liabilities would be disclosed.

205.01(b)(1)(iii) Other Current Liabilities and Deferrals IRC 446, 1031

Other current liabilities and deferrals are generally any current liability that is not an open trade account. Examples may be wages payable, interest payable, bonuses payable, payroll taxes payable, income tax payable, and sales taxes payable.

A cash basis taxpayer may also have current liabilities for items such as pensions payable that were deducted in the current year but paid in the following year, payroll taxes withheld or, in certain states, sales tax collected. When the IRC requires that income be treated as deferred, it would also be included here.

205.01(b)(1)(iv) Estimated and Contingent Liabilities IRC 461

There are three categories of liabilities:

1. Real liabilities.
2. Estimated liabilities.
3. Contingent liabilities.

From an accounting standpoint, real liabilities are those liabilities that do exist and the amount can be determined. Estimated liabilities are those liabilities that do in fact exist but the amount must be estimated. Contingent liabilities are those liabilities that will exist only upon the occurrence of some subsequent event. Only real liabilities are recorded on the balance sheet when on the accrual method. Disclose estimated and contingent liabilities only if notes to the financial statements are included.

205.01(b)(2) Non-Recourse Loans

Non-recourse loans, either current or long-term, bear no economic risk of loss. These loans are classified separately for income tax reporting purposes, and may be presented as its own liability section on the financial statements rather than being classified as either current or long-term. If including notes to the financial statements, the accountant should make a determination as to disclosure of non-recourse loans.

205.01(b)(3) Loans from Shareholders

Loans from shareholders are classified separately for income tax reporting purposes. When classifying loans from shareholders, careful consideration should be given to whether there is written proof as to the debt and the repayment history of the debt. Decisions regarding the classification of the account as to whether it should be classified as a current or long-term liability depend on such findings.

If no evidence of the debt exists, a determination should be made as to whether the amount should be capitalized. If notes to the financial statements are included, the accountant should determine whether a note is warranted concerning the shareholder loan(s). Loans from shareholders may also be presented as a separate section on the financial statements rather than being classified as either a current or long-term liability.

205.01(b)(4) Long-Term Liabilities

Long-term liabilities are obligations due at some date beyond one year's time. When on the accrual method of accounting, long-term debt is split between the portion that becomes payable within the next year as a current liability and the remainder as a long-term liability.

205.01(b)(4)(i) Mortgages, Notes, Bonds Payable in One Year or More

Mortgages, notes, and bonds payable are reported separately for income tax reporting purposes. The account should be adjusted for the current portion of the liability. The long-term portion of mortgages, notes, and bonds payable can be

presented as a separate section on the financial statements or as a long-term liability.

205.01(b)(5) Other Liabilities

The other liabilities section of the balance sheet contains all other liability accounts not otherwise classified as current or long-term liabilities.

205.01(c) Equity/Capital

Equity generally includes accounts for capital contributed to the entity (reduced by returns of capital), retained earnings (or losses), treasury stock (a reduction of equity), and special accounts required for entities such as Sub-chapter S-corporations and not-for-profit organizations.

For all entities, the accountant should make such inquiries of management to determine the cause of any adjustments to equity accounts, and should ensure that the beginning balances in equity accounts match the ending balances from the prior year. Material changes to equity accounts should be explained in either an attached equity statement or in the notes to the financial statements, if notes to the financial statements are presented. For income tax purposes, some entities require the accountant to maintain equity accounts for each partner, shareholder or member. These accounts are generally referred to as capital accounts in these Guidelines. In some cases, the accountant should maintain these individual accounts even when not currently required.

If these accounts are consolidated for financial statement presentation, the accountant should consider use of a schedule with the financial statements to delineate the composition of the consolidated account.

205.01(c)(1) Equity – Proprietorship IRC 61-65

The equity section of a proprietorship consists of the owner's capital account and the owner's drawing account. The capital account of the owner should be analyzed to determine the changes that have occurred during the year. For financial statement purposes, the equity account and the draw account are netted together into a single equity account on the balance sheet.

205.01(c)(2) Equity – Partnership, Limited Partnership and Limited Liability Partnership IRC 701-771

The equity section of a partnership, limited partnership or limited liability partnership consists of multiple capital accounts and corresponding drawing accounts for each partner in the accounting records of the entity. The accountant should analyze these capital accounts and review any relevant partnership documents.

Minimum components include:

1. Balance at beginning of the year per the prior year tax return.
2. Capital contributions during the year.
3. Net income and other increases for the year.
4. Distributions and other decreases for the year.

This total should equal the book ending balance of the account. If not, further analysis is needed to disclose the difference.

The accountant is cautioned to review the beginning capital account balances to see that they reconcile with the ending balances of the prior year. If a problem exists in this area, documentation and verification should be established in detail to support those changes. The books and records of the business should also support changes in capital during the year and supporting documentation should be retained in the work papers. For financial statement purposes, multiple capital and draw accounts are netted together into a single capital account on the balance sheet.

205.01(c)(3) Equity – Limited Liability Company

A single-member LLC is treated as a sole proprietorship for tax purposes unless an election is made to be treated as a corporation. Limited liability companies with more than one member are allowed to choose to be taxed as a partnership or as a corporation. The equity in the company would be reported in the same way it is on the tax return.

When an LLC elects to be taxed as a corporation, the accountant should maintain schedules reflecting each member's share of retained earnings.

The accountant should analyze the capital accounts and review any relevant partnership documents. Minimum components include:

1. Balance at beginning of the year.
2. Capital contributions during the year.
3. Net income and other increases.
4. Distributions and other decreases.
5. Balance at the end of the year.

The accountant is cautioned to review the beginning capital account balances to see that they reconcile with the ending balances of the prior year. If a problem exists in this area, documentation and verification should be established in detail to support those changes. The books and records of the business should also support changes in capital during the year and supporting documentation should be retained in the work papers. For financial statement purposes, the capital accounts and the draw accounts are netted together into a single capital account on the balance sheet. See either section 205.01(c)(4) or 205.01(c)(5), below, for additional guidance depending on whether the entity is filing as a C-corporation or as an S-corporation.

205.01(c)(4) Equity – C-Corporations IRC 301-306

205.01(c)(4)(i) Capital Stock

The corporate financial statement may provide for two types of capital stock:

1. Preferred Stock.
2. Common Stock.

The preferred stock owners have certain preferential rights as to dividends and/or

remaining corporate assets in the event of liquidation.

Common stock reflects the par or stated value of the corporation's issued shares. This account is credited when the shares are originally issued. Entries are made in this account when additional shares are issued or shares are retired.

The accountant should verify in the corporate records if there is more than one class of stock so that these items can be accurately presented on the balance sheet.

205.01(c)(4)(ii) Additional Paid-In Capital

Paid-in capital indicates any excess over par or stated value paid in by stockholders in return for shares issued to them.

The accountant should inquire as to the existence of the paid-in capital in terms of its source and verification of the dollar amount that exists in that account. Particular attention should be paid to any current year changes that have occurred in the paid-in capital or surplus account. The work papers should detail these changes as a form of supporting documentation.

205.01(c)(4)(iii) Retained Earnings – Appropriated

The act of appropriating retained earnings is a policy matter requiring approval by the board of directors. Appropriation is an acceptable practice provided it is shown within the stockholders equity section of the balance sheet and is clearly identified as an appropriation of retained earnings.

Some reasons for such appropriations are:

1. Legal restrictions.
2. Contractual restrictions.
3. Existence of possible or expected loss.
4. Protection of working capital position.

If including notes to the financial statements, and retained earnings have been appropriated, the nature and amount(s) should be disclosed.

205.01(c)(4)(iv) Retained Earnings – Unappropriated

Retained earnings (or losses, if negative) is the accumulation of net income and net losses since the inception of the entity, with certain other increases and decreases. The basic source of retained earnings is usually the accumulated income and loss from operations. Other sources of changes to retained earnings include, but are not limited to, gains or losses on sales of assets, prior period adjustments, unusual income or expenses not charged to operations, dividends paid and Federal income taxes.

The accountant should review the beginning retained earnings balance to see that it reconciles with the ending retained earnings balance of the prior year. If a problem exists in this area, documentation and verification should be established

in detail to support those changes. The books and records of the business should also support changes in retained earnings during the year and supporting documentation should be retained in the work papers.

205.01(c)(4)(v) Adjustments to Shareholders' Equity

Adjustments to shareholders' equity is not an account presented as a line item on the balance sheet. The placement on the tax return of changes to shareholders' equity is discussed in the preceding paragraphs. Like the "accumulated adjustment account" of S-corporations, it is a calculation-based entry on the balance sheet of forms 1120 and 1120S.

205.01(c)(4)(vi) Treasury Stock

The treatment of treasury stock must be in accordance with the IRC. Local law may differ from the IRC as to the treatment of treasury stock. When there is a difference, and notes to the financial statements are included, this difference should be disclosed.

205.01(c)(5) Equity – S-Corporations IRC 1361-1379

205.01(c)(5)(i) Capital Stock

Common stock reflects the par or stated value of the corporation's issued shares. This account is credited when the shares are originally issued. Entries are made in this account when additional shares are issued or shares are retired.

The accountant should review all relevant corporate documents to determine that the entity has not exceeded the provisions in the IRC to maintain its status as an S-corporation.

205.01(c)(5)(ii) Additional Paid-In Capital

Paid-in capital indicates any excess over par or stated value paid in by stockholders in return for shares issued to them.

The accountant should be satisfied as to the existence of the paid-in capital in terms of its source and verification of the dollar amount that exists in that account. Particular attention should be paid to any current year changes that have occurred in the paid-in capital or surplus account. The work papers should detail these changes as a form of supporting documentation.

205.01(c)(5)(iii) Retained Earnings and Other Equity Accounts

S-corporations need to keep several accounts that are made up of the components of a regular corporation's retained earnings account. The IRC places requirements as to which of these accounts must be kept, and to which accounts distributions to shareholders must be charged. Certain elections may also be made with regard to which accounts will be charged with current distributions. Even though some of these accounts may not be required to be kept segregated, it

is suggested the accountant do so in case a change in the status of the S-corporation occurs.

For each of these accounts, the accountant is cautioned to review the beginning balances to see if they reconcile with the ending balances of the prior year. If a problem exists in this area, documentation and verification should be established in detail to support those changes. Calculations will have to be made to assign these changes to appropriate section(s) of the tax return. The books and records of the business should also support changes in account balances of these accounts during the year and supporting documentation should be retained in the work papers.

205.01(c)(5)(iv) Retained Earnings

This account contains earnings and profits that were not distributed prior to becoming an S-corporation. Distributions from this account are always taxable dividends. If there were appropriated and unappropriated retained earnings, the accountant should continue to segregate the two in the event of a change back to a C-corporation. If the corporation was never a C-corporation, this account is not used.

205.01(c)(5)(v) Accumulated Adjustments Account IRC 302, 303, 1368
Accumulated Adjustments Account (AAA), unique to S-corporations, in general, shows the accumulated undistributed net income of the corporation during its S-corporation status. In certain circumstances, it may not be required, but since certain eventualities may require its calculation, it is recommended that all S-corporations maintain the AAA.

At the end of the tax year, the AAA is determined by taking into account the taxable income, deductible losses and expenses, and nondeductible losses and expenses for the tax year. Adjustments for nontaxable income are made to the other adjustments account, as explained below.

Under the IRS ordering rules, distributions are generally applied against the AAA first, unless certain elections are made. The accountant should be familiar with the IRC and related regulations in order to properly allocate distributions to this or other equity accounts.

Adjustments may be required to this account in the case of redemptions that are treated as a sale or exchange under IRC Sections 302(a) or 303(a).

205.01(c)(5)(vi) Other Adjustments Account IRC 1368

Tax-exempt income, along with related expense and Federal taxes incurred during a C-corporation tax year, are adjustments to the other adjustments account. The account should then be reduced by the amount of any distributions. Distributions made from this account would be tax free.

205.01(c)(5)(vii) Shareholders' Undistributed Taxable Income Previously Taxed

The shareholders' undistributed taxable income previously taxed account, also referred to as previously taxed income (PTI), must have a balance at the beginning of the current tax year or no adjustment should be made to this account. If the account has a balance, the only adjustment to be made is to reduce the account for distributions made under IRC section 1375(d) (as in effect prior to the enactment of the Sub-chapter S Revision Act of 1982).

Unlike the AAA, an individual shareholder's right to nontaxable distributions from PTI may not be transferred to another person. Therefore, the S-corporation must keep records for each shareholder's net portion of PTI.

205.01(c)(5)(viii) Adjustments to Shareholders' Equity

Adjustments to shareholders' equity is not an account presented as a line item on the balance sheet. The placement on the tax return of changes to shareholders' equity is discussed in the preceding paragraphs.

205.01(c)(5)(ix) Treasury Stock

The treatment of treasury stock must be in accordance with the IRC. Local law may differ from the IRC as to the treatment of treasury stock. When a difference exists, and notes to the financial statements are included, this difference should be disclosed.

205.01(c)(6) Not-for-Profit Organizations

Not-for-profit organizations are usually corporations, but can include certain kinds of trusts. They generally do not have capital stock but may have in certain circumstances.

Not-for-profit organizations may choose to follow "Financial Statements of Not-for-Profit Organizations No. 117 (FAS 117)," in which case equity is referred to as "net assets," which are classified as unrestricted, temporarily restricted and permanently restricted. Some states require the use of FAS 117. If the organization does not follow FAS 117, corporations show equity as retained earnings, trusts use terms such as accumulated income, and organizations that use fund accounting refer to equity as fund balances.

205.01(c)(6)(i) Organizations Following FAS 117

Organizations that follow FAS 117 must allocate the net assets into the following three categories:

1. Unrestricted Funds.
2. Temporarily Restricted Funds.
3. Permanently Restricted Funds

205.01(c)(6)(ii) Organizations Not Following FAS 117

Organizations that do not follow FAS 117 must use the following designations for the fund or equity accounts:

1. Capital Stock, Trust Principal, or Current Funds.
2. Paid-In or Capital Surplus, or Land, Building and Equipment Fund.
3. Retained Earnings or Accumulated Income, Endowment or Other Funds.

205.02 Preparation of Statement of Revenues and Expenses – Income Tax Basis

The Statement of Revenues and Expenses is prepared as a periodic recognition and measurement of revenues and expenses over a particular period of time. Generally, cash basis statements refer to expenditures rather than expenses. The statement must identify the period covered.

205.02(a) Income IRC 1, 61, 77, 108, 110, 111, 446, 447, 451, 453, 481, 631, 1031, 1033, 1044, 1060, 1201, 1202, 1231, 1237, 1241, 1253, 7872

Income must be reported in accordance with the IRC, and consistent with the tax return.

“Gross income” means all income from whatever source derived. Income from operations is income that is generated from the entity’s normal course of business for which it was created.

Items of revenue, which are not income from operations, should be specifically determined and identified (investment income and other income) and so classified on the financial statements.

Income items that are not required to be included on the tax return should be included on the statement of revenues and expenses and reconciled through the income reconciliation statement.

205.02(b) Expenses IRC 162

To qualify as a business expense, the item must be ordinary, necessary, reasonable and related to the business operations. In addition, the item should be allowed by a specific section of the IRC.

Ordinary business expense items that may not be deductible, or only partially deductible, under the IRC must be shown on the statement of revenues and expenses and reconciled through the income reconciliation statement.

205.02(c) Cost of Goods Sold

To maintain consistency with the preparation of the year-end tax return, the cost of goods sold section of the financial statements should be maintained in the same manner as it is presented on the tax return. Purchases, cost of labor, and other additional costs defined in the IRC are added to beginning inventory and reduced by the amount of ending inventory to arrive at cost of goods sold. The accountant should obtain the required information to calculate cost of goods sold from management. It is permissible to use an “Inventory

Change” account on the financial statements to account for the net different between beginning and ending inventories.

205.02(d) Income Tax Liability and Credits Against Tax IRC 1-15, 21-52, 53-59B, 701, 1374

If the entity is subject to taxation, and uses the accrual method of accounting, then the financial statements must include the current year income tax liability, net of any credits, as determined based on the IRC and regulations.

205.03 Preparation of Income Reconciliation Statement

The Income Reconciliation Statement is prepared to reconcile financial statement book net income (loss) to taxable income (loss) on the tax return for year-end statement presentations.

205.04 Preparation of Statement of Cash Flows – Income Tax Basis

The Statement of Cash Flows – Income Tax Basis is prepared to show the cash and cash equivalents consequences of the periodic operating, financing and investing activities for year-end statement presentations. Users of these Guidelines should refer to Statement of Financial Accounting Standards No. 95 (FAS 95) for authoritative guidance on the preparation of this statement.

205.05 Treatment of Items for Which the IRC Has No Provision

In situations where the IRC is silent as to treatment, the item must be recorded in a manner consistent with the tax return. Care should be taken to make certain that the expense is truly “ordinary and necessary” so that the accountant is confident that the classification will stand up to the “reasonable expectation” requirements of Circular 230.

TAGSB – Section 3 Reporting

300.00 Engagement Letter

It is strongly suggested that an engagement letter be used with all clients to delineate those services that will be provided.

301.00 The Accountant's (Preparer's) Report

301.01 Year-End Report

The accountant's report (where permitted by local law) sets forth the method of presentation. The financial statements are an integral part of the accountant's report.

The report is a communication by the accountant to the owners, partners, shareholders or principals of the accounting entity. The accountant should take care to assure that the report is in compliance with individual local law requirements, which may differ from these Guidelines. The accountant's report is prepared on firm letterhead or comparable format and should be dated the day the work was completed, not the date the financial statements are "as of."

The accountant's report (where permitted by local law) should include:

1. Letter dated the date of work paper completion.
2. Appropriate addressee.
3. Business/client name.
4. Financial statements presented, with a statement that the accountant has compiled or prepared them.
5. Periods involved.
6. Statement that the accompanying financial statements have not been audited or reviewed.
7. Financial statement presentation basis of accounting, such as cash, accrual, hybrid or other method recognized by the Internal Revenue Service.
8. Name of statement preparer (accounting firm).
9. Reference to the notes to the financial statements or a statement that notes are limited or not included.

301.02 Interim Report

It is appropriate to place a minimal number of disclosures, such as "inventory is only taken at year-end" or "the cost of goods sold is calculated based on the prior year's gross profit percentage," in the accountant's report when not preparing notes to the financial statements

In addition, the accountant's report, if permitted by local law, should indicate:

1. The period covered is for the partial period rather than a full year.
2. The accompanying statements are interim presentations and should therefore not be relied upon in the same manner or given the same weight as year-end presentations.
3. That income tax decisions frequently are made only at or near year-end and could change the apparent performance of the business from that which is presented here.

4. That certain significant information may not be available until year-end.

302.00 Accountant's Report – General Language

State and local laws govern the use of report language and the accountant should be familiar with local requirements when issuing the accountant's report or transmittal letter. Some states, by statute or Board of Accountancy rule, may allow or require the use of "safe harbor" language by non-licensees.

302.01 Material Event

If the accountant has knowledge of a material event that occurs after the balance sheet date but before the issuance of the accountant's report, and it would lead the reader to arrive at a different conclusion about the financial status of the entity, the accountant should disclose the nature of the event in the accountant's report or withdraw from the engagement.

303.00 Tax Basis Financial Statements – Year-End

The presentation of year-end tax basis financial statements prepared using these Guidelines should follow traditional financial statement presentation and classification methodologies appropriate to the entity.

303.01 Required – Full Disclosure

Full disclosure using these Guidelines consists of the following:

1. Accountant's Report.
2. Balance Sheet – Income Tax Basis.
3. Statement of Revenues and Expenses – Income Tax Basis.
4. Statement of Retained Earnings (can be combined with the Statement of Revenues and Expenses).
5. Income Reconciliation Statement.
6. Statement of Cash Flows – Income Tax Basis.
7. Notes to the Financial Statements.

303.02 Optional – Full Disclosure

Optional disclosures using these Guidelines may consist of the following:

1. Equity Schedule.
2. Cost of Goods Sold Schedule.
3. Comparison of Prior Years.
4. Other Related Schedules.

304.00 Exception To Full Disclosure

The accountant may use these Guidelines to prepare financial statements without notes to the financial statements. However, in those instances and if permitted by local law, the accountant's report should include a paragraph (such as the one given below) indicating the omission of these items and the effect that these omissions may have on the user's conclusions about the company's financial condition, results of operations, cash and cash equivalents and cash flows.

Management has [The owners have] decided to omit most of the disclosures usually included in financial statements prepared on the income tax basis of accounting. If the omitted disclosure(s) were included in the financial statements, they might influence the user's conclusions about the company's financial condition. Accordingly, these financial statements are not intended for those who are not informed about such matters. If additional information is required, the reader should request it of management.

305.00 Financial Statements – Required Comment

The following statement, if permitted by local law, should appear at the bottom of each page of the year-end financial statements, if notes to the financial statement are included:

See accountant's report and notes to the financial statements.

Otherwise, if notes to the financial statements are not included, the following would be used, if permitted by local law:

See accountant's report.

306.00 Format of Financial Statements

The accountant may use the standard classified format presentation in the preparation of all financial statements, or any other format that the accountant deems appropriate for the engagement, so long as all of the income and expense elements of a standard presentation are included. It is acceptable to footnote or schedule any information from the financial statements.

306.01 Non-Deductible Expenses

Non-deductible or partially deductible expenses can be reported either in operating expenses or as a separate category. If reported within the operating expenses section, such expenses should be asterisked and a footnote made as to the non-deductibility or partial deductibility. If reported as a separate category, net income would change to net taxable income, and the nondeductible or partially deductible expense would be subtracted from net taxable income with the result being net operating income. This treatment should apply to both interim and year-end statements.

306.02 Amended Financial Statements

When it is necessary to issue corrected financial statements, the word "Amended" should be added to the beginning of each statement name (i.e., Amended Balance Sheet – Income Tax Basis).

307.00 Notes to the Financial Statements and Other Attachments

307.01 Notes

The notes to financial statements explain the nature of monetary values in a financial statement. Disclosures are information included in a financial statement presentation to enable the reader to better understand the statements. Schedules support amounts on a

financial statement and are not in themselves notes, explanations, or disclosures. Whether the accountant is preparing full-disclosure, partial disclosure or no disclosure, any deviation in the financial statements from the tax return as to the amount or manner in which an item is reported, should be disclosed. Because these are tax based financial statements, the reader will assume agreement exists between the tax return and the financial statements. Therefore, if a deviation exists, the accountant should inform the reader.

For full disclosure financial statements, notes are a required part of the presentation. Where full disclosure statements are not presented, a paragraph stating that notes and other disclosures to the financial statements are omitted, in full or in part, should be in the accountant's report.

If no disclosures are necessary, the "Notes" section to the financial statements is omitted.

The preferred methods of disclosure for financial statements prepared using these Guidelines are full disclosure and no disclosure. Partial disclosure is acceptable but not recommended. The term "Notes" should not be used in conjunction with non-full disclosure financial statements. If only partial disclosure is made, it should be explicitly conveyed that only a portion of the information is being presented. See 304.00, above, for suggested wording to be used in the report section of the statements. The following language as a header for this section is suggested:

SELECTED INFORMATION

Management has [The owners have] elected to disclose only a selected portion of the information required for full disclosure financial statements prepared on the income tax basis of accounting. Management [The owners] chose the disclosure(s) to be made a part of this presentation with full knowledge that the information disclosed represents less than all of the required disclosures.

Accountants should use their best judgment in determining the appropriate content of the notes to the financial statements. See the Appendices for examples and checklists.

When the inclusion of a note is optional, the accountant is guided by whether or not the item is material or could lead the reader to a different conclusion regarding the statements or the entity, in part or as a whole.

307.02 Other Attachments

Other attachments or supplemental schedules may be used to provide greater detail for any consolidated amount shown in the financial statements. These attachments give the reader greater insight to the financial statements and are usually prepared to aid management but can be produced for any number of reasons or purposes. An example of an "other attachment" is a list of ratios that have been computed at the request of management. However, use of a schedule or "other attachment" does not take the place of a note. When a note is required, only a note to the financial statements will suffice.

308.00 Interim Financial Statements

308.01 General

Interim financial statements are for periods of less than an entire tax year and as such are an incomplete presentation. Interim financial statements are an integral component of managing a business and, as such, provide management with progress reports on the year thus far completed.

Because interim financial statements are an incomplete presentation of the tax year, these Guidelines do not require the same presentation as at year-end.

308.02 Required Items

The following items should be included in an interim financial statement presentation.

1. Accountant's Report.
2. Balance Sheet – Income Tax Basis.
3. Statement of Revenues and Expenses – Income Tax Basis.

308.03 Optional Items

The following is a list of items that are specifically made optional in these Guidelines for interim statements. Accountants should use their professional judgment and consult with management on the appropriateness of forgoing these items for interim statement purposes. When the accountant is aware that the financial statements are going to be given to a third party, deviations from required items for year-end presentation should be disclosed in the notes to the financial statements or in the accountant's report, depending on local law.

1. Accounts that have been split between their current portion and the non-current portion do not have to have the current portion adjusted for interim statement purposes. It is recommended that periodic payments of principle be charged against the non-current portion of the principle during this period, if this option is used.
2. If estimated income taxes are not included in the interim financial statements of an entity subject to taxation, this omission should be a part of the notes to the financial statements or included in the accountant's report.
3. Additional statements and schedules may be prepared at the request of management, but are not required.
4. Use of estimates for interim statements on items such as cost of goods sold is acceptable, but when estimates are used in the presentation, the existence of that estimate and a description of the basis for the estimate should be included in the notes to the financial statements or included in the accountant's report.
5. Notes to the Financial Statements are optional.
6. Income Reconciliation Statement is optional.
7. Statement of Cash Flows is optional.

309.00 Internal Use Only Statements

Internal Use Only financial statements are acceptable under these Guidelines. First and foremost, the accountant should, if issuing Internal Use Only financial statements, have an engagement letter with the client specifically stating that this type of financial statement is what

the client has agreed will be produced by the accountant and that the client cannot and will not under any circumstances give a copy of the Internal Use Only financial statements to a third party. Local law may control the wording of such agreements.

Each page of the financial statements should be printed on plain white paper and be plainly marked at the bottom of each page “*Internal Use Only*.”

Under Internal Use Only statements, only the balance sheet and the statement of revenues and expenses are presented. They are produced using the same guidance as to form and content as in other presentation formats contained in these Guidelines.

Unless local law requires otherwise, the accountant’s report and notes to the financial statements are not produced under the Internal Use Only presentation format.

310.00 Reading of the Financial Statements

Regardless of the type of financial statement being prepared, the accountant should read the financial statements upon their completion to determine if they are in the proper format and contain no apparent material errors, including both clerical and mathematical errors. The accountant should exercise the level of diligence required by the IRC.

Even in cases where it has been elected that full disclosure not be made, the accountant’s standard of care requires that if the accountant knows of information the omission of which would tend to mislead the financial statement reader, disclosure of such information must be made or the accountant should withdraw from the engagement.

The accountant is accepting information provided by the client, and may accept it if it appears reasonable in the accountant’s professional opinion. If the information does not appear to be reasonable, then the accountant must make additional inquiry. If the further information does not satisfy the accountant’s concerns, and/or the client refuses to make the appropriate adjustments, the accountant should withdraw from the engagement.

Appendices

These Appendices provide supplementation information and are considered an integral part of TAGSB. They serve, therefore, as a form of official interpretation of the Guidelines.

It is recommended that all appropriate authorities be consulted to ascertain any restrictions imposed by the pertinent jurisdiction that might apply to the use of these Guidelines. Differences between laws vary widely from jurisdiction to jurisdiction, and the samples contained in these Appendices are always subject to modification when in conflict with state and local statutes, rules, and regulations.

Appendix A	Notes and Disclosures
Appendix B	Engagement Letter
Appendix C	Full Disclosure Checklist (Long Form)
Appendix D	Financial Statement Checklist (Short Form)
Appendix E	Accountant's Report Checklist (Short Form)
Appendix F	Sample Accrual Basis Financial Statements – Full Disclosure
Appendix G	Sample Cash Basis Financial Statements – No Disclosure
Appendix H	Additional Recommended Reference Materials

Appendix A

Notes and Disclosures

When preparing to write notes to the financial statements, the accountant should always keep in mind that notes to the financial statements prepared using these Guidelines are generally principle-based or objective-oriented rather than rule-driven. The objective of financial statements prepared using these Guidelines is to provide the reader with clearly understandable financial information that has been compiled from data provided by management and analyzed by the accountant for its appropriateness, using the principles contained in the NSA Code of Ethics, the NSA Rules of Professional Conduct and U.S. Treasury Circular 230 as they apply to accounting based on the Internal Revenue Code to compute business income.

Above all, the financial statements need to be fully understood by users other than the accountant. Notes and disclosures are meant to enhance the reader's knowledge of the business, its profitability and to make the statements more understandable. The accountant should keep the concerns of creditors in mind (their perception of the entity's ability to pay its liabilities as they become due, and what collateral may be available) when considering what notes are required for a given client.

The intent of TAGSB with respect to notes to the financial statements is to relieve the accountant and the business owner of the regulatory overload of a totally rule-based system that serves no genuine need of small business. Notes to the financial statements are one of the major areas where TAGSB can significantly reduce the otherwise burdensome requirements of other systems, which in turn translates to lower cost to the business client without decreasing the readability or reliability of the financial presentation.

Appendix B

Engagement Letter

The use of an engagement letter is strongly recommended (see Section 300.00). Also, Federal and state laws and regulations may dictate additional statements and disclosures for the engagement letter. In general, an engagement letter should:

1. Be addressed to the client.
2. Describe the type of entities involved.
3. Define the period to be covered by financial statements.
4. Define the period of time covered by the engagement itself.
5. State the scope of service, including nature and limitations of scope of service.
6. Identify the method of accounting to be used.
7. State that the accountant will not audit, or review, or express any opinion on the financial statements.
8. Include a sample of accountant's report expected to be used.
8. If no disclosures, the report should include the pertinent statement.
9. Explain that the engagement cannot be relied on to discover errors, fraud, illegal acts, etc.
10. Include a statement of what will happen if the accountant withdraws or is unable to complete the engagement.
11. State that the financial statements are the responsibility of management/owners.
12. Describe any additional services to be provided.
13. Include a statement of fee arrangements and terms of payment.
14. When Internal Use Only financial statements are going to be prepared, include a statement that the client agrees the financial statements are not to be given to or used by a third party.
15. Have a place for the client to acknowledge and sign indicating agreement with the terms.

Many situations are unique and the engagement letter may require additional items.

The accountant is encouraged to seek samples of engagement letters from other authoritative sources.

Appendix C

Full Disclosure Checklist (Long Form)

Each question needs to be answered. The N/A column should be used when the item either does not exist or is not material. All “No” answers must be explained on an Explanation of “No” Answers form.

Client _____

Preparer _____ Date _____

ACCOUNTANT’S REPORT	YES	NO	N/A
1) Is the compilation limited to presenting in the form of financial statements information that is the representation of management (owners)?	_____	_____	_____
2) Since the financial statements have not been audited or reviewed, does the report state that the accountant does not express an opinion or any other form of assurance on them?	_____	_____	_____
3) If the accountant is not independent with respect to the entity whose financial statements have been compiled, did the accountant modify the last paragraph of his/her report?	_____	_____	_____
4) Does each page of the compiled financial statements include a reference to the accountant’s compilation report?	_____	_____	_____
5) If the accountant compiled both the basic financial statements and other data which is presented for supplementary analysis purposes, does the compilation report reference the other data?	_____	_____	_____
6) Is the report properly dated?	_____	_____	_____
7) Does the accountant’s report cover all periods presented, including all interim periods?	_____	_____	_____
8) Does the report adequately disclose all other matters and contain all of the elements required by professional standards?	_____	_____	_____

YES NO N/A

BALANCE SHEET

9) Have assets and liabilities been segregated into current and non-current classifications, where appropriate? _____

10) Have valuation allowances been provided for such items as doubtful receivables and inventories whose cost exceeds market value? _____

Cash

11) Are restrictions on cash properly disclosed and are restricted amounts appropriately segregated from other cash items, showing restricted cash as a non-current asset if appropriate? _____

12) Are material bank overdrafts presented as a separate caption among current liabilities? Similarly, are material dollar amounts of held checks (checks on the bank reconciliation but not released until after the balance sheet date) reclassified as accounts payable? _____

13) Are significant concentrations of credit risk arising from cash deposits in excess of federally insured limits disclosed? _____

Notes and Accounts Receivable

14) Are all significant categories of receivables segregated from normal trade receivables, e.g., tax refunds, advance payments on purchases, amounts due from officers, employees, directors, stockholders and affiliates? _____

15) Are amounts due from affiliates or subsidiaries classified as current only if it is the company's practice to liquidate them periodically and the current financial position of the affiliate or subsidiary warrants this treatment? _____

16) Is the allowance for doubtful accounts disclosed? _____

17) Have notes been adjusted for interest rates that do not reflect market rates and/or imputed interest? _____

Inventories

18) Is the basis for stating inventories disclosed, including the method of determining cost? _____

YES NO N/A

19) If practicable, are the major classes of inventories, such as finished goods, work in process, materials, and supplies disclosed?

Property and Equipment

Are the following disclosed relating to depreciable assets:

20) Balance of major classes of depreciable assets, by nature or function, at the balance sheet date?

21) Accumulated depreciation, by class or in total, at the balance sheet date?

22) A general description of the method(s) used in computing depreciation with respect to major classes of depreciable assets?

23) Depreciation expense for the period?

24) If property and equipment are impaired or being held for disposal, have the required disclosures been made?

Current Liabilities (Except Income Taxes)

25) Are significant categories segregated, e.g., accounts payable, accrued expenses, customer deposits, interest payable, amounts due to officers or employees, notes payable, and current maturities of long-term debt?

Notes Payable, Long-Term Debt, and Other Obligations

26) Are interest rates, maturity dates, restrictive covenants, subordinate features and pledged assets disclosed?

27) If a note is non-interest bearing or has an unreasonable stated interest rate, has interest been imputed at a market rate and appropriately accounted for and disclosed?

28) Are current portions of debt obligations presented as current liabilities?

	YES	NO	N/A
29) Does the current liability classification include obligations that by their terms are due on demand or will be due on demand within one year (or operating cycle, if longer) from the balance sheet date, even though liquidation may not be expected within that period?	_____	_____	_____
Does that current liability classification include long-term obligations that are or will be callable by the creditor either because the debtor's violation of a provision of a debt agreement at the balance sheet date makes the obligation callable or because the violation, if not cured within a specified grace period, will make the obligation callable unless one of the following conditions is met:			
30) The creditor has waived or subsequently lost the right to demand payment for more than one year from the balance sheet date?	_____	_____	_____
31) It is probable that the debtor will cure the violation within the grace period?	_____	_____	_____
32) If obligations under the above are classified as long-term liabilities, are the circumstances disclosed?	_____	_____	_____
33) Are the combined aggregate amounts of maturities and sinking fund requirements for all long-term borrowings disclosed for one year following the date of the latest balance sheet presented?	_____	_____	_____
34) Are debt issue costs reported in the balance sheet as deferred charges?	_____	_____	_____
Income Taxes			
35) If the company is an S-corporation, partnership or proprietorship, do disclosures explain why income tax expense is not recorded?	_____	_____	_____
36) Assuming the entity is taxed, are taxes currently payable or refundable, appropriately classified in the balance sheet?	_____	_____	_____
37) Do disclosures regarding income taxes include the amounts and expiration dates of operating loss and tax credit carry forwards for tax purposes?	_____	_____	_____

YES NO N/A

Stockholders' Equity

38) Are classes of capital stock presented in order of priority in liquidation? _____

39) Are the legal title of securities, par or stated values, rights and preferences, number of shares authorized, issued and outstanding disclosed? _____

40) Are changes in separate accounts comprising stockholders' equity and changes in the number of shares of equity securities disclosed? _____

41) Are changes in the capital accounts of S-corporations, limited liability companies, partnerships and proprietorships disclosed? _____

STATEMENT OF INCOME

42) Are the major categories of revenue and expense items, such as sales, cost of goods sold and selling and administrative expenses shown separately on the face of the income statement? _____

43) Are sales or operating revenues shown net of discounts, allowances, returns, etc? _____

44) Are cost of goods sold and expenses shown net of purchase discounts? _____

45) For each accounting period presented, has the total amount of interest costs incurred, charged to expense and capitalized been disclosed? _____

46) Are material events or transactions that are either unusual in nature or of infrequent occurrence, but not both (and therefore not meeting the criteria for extraordinary items), properly reported and disclosed? _____

47) Have the nature of the event or transaction and the principal items entering into the determination of an extraordinary gain or loss been disclosed? _____

STATEMENT OF CASH FLOWS

48) If this is a year-end statement, has the statement of cash flows been included or, if this is an interim statement, has the reference to the statement of cash flows been removed from the report language? _____

	YES	NO	N/A
Does the statement of cash flows:			
49) Use words that adequately describe cash and cash equivalents?	_____	_____	_____
50) Separate cash receipts and cash payments into operating, investing and financing activities?	_____	_____	_____
51) Report all cash inflows and outflows separately rather than netted? For instance, loan proceeds are an inflow which are to be reported separately from payments on the loan, which are an outflow.	_____	_____	_____
52) Classify cash flows from sale, purchase or maturity of trading securities as operating cash flows?	_____	_____	_____
53) Show the net effect of cash flows on cash and cash equivalents during the period in a manner that reconciles beginning and ending cash and cash equivalents?	_____	_____	_____
54) Provide a reconciliation of net income and net cash flows from operating activities that reports all major classes of reconciling items separately, including changes during the period in receivables and payables pertaining to operating activities and in inventory?	_____	_____	_____
55) Do the beginning and ending balances of cash and cash equivalents on the statement of cash flows match similar amounts on the balance sheet?	_____	_____	_____
56) Are non-cash investing and financing transactions disclosed either in narrative form or summarized in a schedule?	_____	_____	_____
57) If cash equivalents are shown, is the accounting policy for determining which items are treated as cash and cash equivalents disclosed?	_____	_____	_____
58) Are the amounts of cash paid during the year for interest (net of any amount capitalized) disclosed?	_____	_____	_____
59) If there were any related party transactions during the year, have they been disclosed (required disclosure)?	_____	_____	_____
60) For line items that use the words "increase" or "decrease," does the word match the actual change?	_____	_____	_____

YES NO N/A

GENERAL FINANCIAL STATEMENT DISCLOSURES

Accounting Policies

61) Are all significant accounting policies presented in the first note or in a separate schedule?

62) Have changes in accounting policies been properly reported and disclosed?

Related Party Transactions and Common Control

Do disclosures of material related party transactions include:

63) The nature of the relationship(s)? (If necessary to an understanding of the effects of the transactions, the related party should be identified.)

64) A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which an income statement is presented and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements?

65) The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period?

66) Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement?

67) If the company and one or more other companies are under common control and the existence of that control could result in operating results or financial position of the company significantly different from those that would have been obtained if the companies were autonomous, has disclosure been made of the nature of the control relationship, even though there have been no transactions between the companies?

YES NO N/A

Pension Plans – Defined Contribution Plans

Is the following information about the company’s defined contribution plan disclosed:

68) A description of the plan(s), including employee groups covered, the basis for determining contributions, and the nature and effect of significant matters affecting comparability information for all periods presented?

69) The amounts of cost recognized during the period?

Leases in Financial Statements of Lessees

General disclosures:

70) Have the nature and extent of leasing transactions with related parties been disclosed?

71) Has a general description of the company’s leasing arrangements been disclosed?

Has disclosure of the following been made for operating leases having initial or remaining noncancellable lease terms in excess of one year:

72) Future minimum rental payments required as of the date of the latest balance sheet presented?

73) The total amount of minimum rentals to be received in the future under noncancellable subleases as of the date of the latest balance sheet presented?

74) Has disclosure been made of rental expense for each period for which an income statement is presented, with separate amounts for minimum rentals, contingent rentals and sublease rental income?

Financial Instruments

75) Have significant concentrations of credit risk from all financial instruments been disclosed, including identification of the characteristic(s) of the concentration, possible accounting loss and information regarding collateral?

YES NO N/A

Contingencies

76) Is the nature and amount of an accrued loss contingency disclosed?

For loss contingencies not accrued, do disclosures include:

77) Nature of the contingency?

78) Estimate of possible loss or range of loss, or a statement that such estimate cannot be made?

If there is a substantial doubt about a company's ability to continue as a going concern for a period of time not to exceed one year beyond the balance sheet date, do the financial statements adequately disclose the following:

79) Pertinent conditions and events giving rise to the assessment of substantial doubt about the company's ability to continue as a going concern for a period of time not to exceed one year from the balance sheet date?

80) The possible effects of such conditions and events?

81) Management's evaluation of the significance of those conditions and events?

82) Possible discontinuance of operation?

83) Management's plans (including relevant prospective financial information)?

84) Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities?

Risks and Uncertainties

Have the following disclosures about the company's products or services been made:

85) A description of the major products or services the company sells or provides and its principal markets, including the location of those markets?

	YES	NO	N/A
86) If the company operates in more than one business, the relative importance of its operations in each business and the basis for that determination (e.g., based on assets, revenues, or earnings)?	_____	_____	_____
Other Items To Consider For Proper Presentation			
87) Accounting changes and correction of an error.	_____	_____	_____
88) Business combinations – pooling of interests.	_____	_____	_____
89) Business combinations – purchase.	_____	_____	_____
90) Discontinued operations.	_____	_____	_____
91) Employee stock ownership plans.	_____	_____	_____
92) Extinguishment of debt.	_____	_____	_____
93) Lending activities and loan purchases.	_____	_____	_____
94) Limited liability companies or partnerships.	_____	_____	_____
95) Long-term contracts.	_____	_____	_____
96) Non-monetary transactions.	_____	_____	_____
97) Pension plans – defined benefit (including settlements and curtailment of plans and termination benefits).	_____	_____	_____
98) Pre-acquisition contingencies of purchased companies.	_____	_____	_____
99) Post-employment benefits.	_____	_____	_____
Post-retirement benefits other than pensions:			
100) Defined benefit plans.	_____	_____	_____
101) Defined contribution plans.	_____	_____	_____
102) Quasi-reorganization.	_____	_____	_____
103) Retained earnings restrictions.	_____	_____	_____
104) Rights and privileges of common and preferred stock.	_____	_____	_____

Appendix D

Financial Statement Checklist (Short Form)

	YES	NO	N/A
Is Client's name listed at top of each page?	_____	_____	_____
Use the report titles as follows:			
Balance Sheet – Income Tax Basis	_____	_____	_____
Statement of Revenues and Expenses – Income Tax Basis	_____	_____	_____
Retained Earnings Statement <i>or</i>	_____	_____	_____
Statement of Owners Equity <i>or</i>	_____	_____	_____
Statement of Member's Equity <i>or</i>	_____	_____	_____
Statement of Partner's Equity	_____	_____	_____
Income Reconciliation Statement	_____	_____	_____
Statement of Cash Flows – Income Tax Basis	_____	_____	_____
Notes to Financial Statements	_____	_____	_____
Footnotes			
See Accountant's Report and Notes To Financial Statements	_____	_____	_____
See Accountant's Report	_____	_____	_____
Internal Use Only	_____	_____	_____

Caveat: We strongly suggest that you check your state and local laws governing the use of report titles and footnotes. Some states may have restrictions on the terms used in this checklist.

Appendix E

Accountant's Report Checklist (Short Form)

	YES	NO	N/A
Prepared on firm letterhead or comparable format.	_____	_____	_____
Indicates the date this report is prepared. May be listed here or at end of text.	_____	_____	_____
Indicates officer's or members name or board of directors and then the company's name and address.	_____	_____	_____
First Paragraph			
Should state what reports are included in this financial Statement, and in the order in which they appear.	_____	_____	_____
The period of time covered by these financials.	_____	_____	_____
Whether financials are prepared or compiled.	_____	_____	_____
State basis of accounting used for income tax—accrual or cash.	_____	_____	_____
Second Paragraph			
Limitation of the preparation or compilation of financial statements.	_____	_____	_____
A statement that I (we) have not audited or reviewed these financials.	_____	_____	_____
Other Items			
Is management electing to omit all disclosures? If so, a paragraph is needed stating this.	_____	_____	_____
Are corporate income taxes accrued or not? If so, a paragraph is needed stating this.	_____	_____	_____

YES NO N/A

Are you independent with respect to this client. If not, you need to state this in a paragraph, but not the reason why.

Last

Name of statement preparer

Caveat: It is strongly suggested that you check your state and local laws governing the Accountant's Report and its use. Some states may have restrictions on the term "compile" or "prepare" and you may need to use safe-harbor language instead of what is recommended with this checklist.

Appendix F

Sample Accrual Basis Financial Statements – Full Disclosure

**XYZ Accounting & Tax Service, Inc.
3600 E. Street, Somewhere, Oklahoma 73000**

John Smith, President
ABC Co., Inc.
1234 Stone Ave.
Anywhere, OK 73333

**—EXAMPLE NOT INCLUDED—
CONTENT MUST BE IN CONFORMANCE WITH
REQUIREMENTS OF YOUR STATE**

April 24, 20XX

XYZ Accounting & Tax Service, Inc.

ABC Co., Inc.

**Balance Sheet – Income Tax Basis
As of December 31, 20XX**

Current Assets:

Cash	\$ 14,401.38
Accounts Receivable – Trade	27,282.25
Inventory	82,188.90
Loan — Short Term	<u>3,223.77</u>
Total Current Assets	<u>127,096.30</u>

Fixed Assets:

Buildings & Other Depreciable Assets	92,011.31
Accumulated Depreciation	(18,858.20)
Land	<u>30,000.00</u>
Total Fixed Assets	<u>103,153.11</u>

Other Assets:

Organization Cost	50.00
Accumulated Amortization	(43.72)
Goodwill	338,110.00
Accumulated Amortization	(73,248.00)
Deposits	555.00
Cash Bond	<u>500.00</u>
Total Other Assets	<u>265,923.28</u>
Total Assets	<u><u>\$496,172.69</u></u>

See Accountant's Report and Notes to the Financial Statements.

ABC Co., Inc.

**Balance Sheet – Income Tax Basis
As of December 31, 20XX**

Current Liabilities:

Accounts Payable	\$ 6,588.29
Payroll Taxes Payable	1,402.23
Sales Tax Payable	7,081.08
Loans – Bank	50,000.00
Corporate Income Tax Payable	4,100.00

Total Current Liabilities 69,171.60

Long Term Liabilities:

Loans – Bank - In More Than 1 year	<u>400,304.59</u>
------------------------------------	-------------------

Total Long Term Liabilities 400,304.59

Total Liabilities 469,476.19

Stockholders' Equity:

Capital Stock	500.00
Retained Earnings	<u>26,196.50</u>

Total Stockholders' Equity 26,696.50

Total Liabilities & Equity \$496,172.69

See Accountant's Report and Notes to the Financial Statements.

ABC Co., Inc.

**Statement of Revenues and Expenses – Income Tax Basis
For the Year Ended December 31, 20XX**

Sales	\$2,291,940.07
Cost of Goods Sold:	
Beginning Inventory	80,176.70
Purchases	2,114,510.17
Cost of Labor	44,792.77
Total	<u>2,239,479.64</u>
Less: Ending Inventory	<u>(82,188.90)</u>
Total Cost of Goods Sold	<u>2,157,290.74</u>
Gross Profit	<u>134,649.33</u>
Expenses:	
Alarm	240.00
Amortization Expense	22,551.00
Bank Fees	2,703.25
Cash Shortage	1,673.51
Depreciation	4,387.21
Dues & Publications	95.00
Entertainment	161.23
Flowers & Gifts	522.35
Insurance	6,830.73
Interest	37,246.21
Licenses & Permits	80.00
Mileage Paid	4,384.99
Office Supplies	112.81
Payroll – Officer	14,958.28
Payroll Taxes	4,912.88
Postage	77.65
Repair & Maintenance	2,444.25
Returned Checks	4,103.89
Taxes – Cigar	69.28
Taxes – Property	1,210.87
Telephone	1,330.08
Travel Expense	194.08
Utilities	<u>5,160.39</u>
Total Expenses	<u>115,449.94</u>

See Accountant's Report and Notes to the Financial Statements.

ABC Co., Inc.

**Statement of Revenues and Expenses – Income Tax Basis
For the Year Ended December 31, 20XX**

Net Income Before Taxes	<u>19,199.39</u>
Corporate income tax – federal	(2,900.00)
Corporate income tax – state	<u>(1,200.00)</u>
Net Income After Taxes	<u><u>\$ 15,099.39</u></u>

See Accountant's Report and Notes to the Financial Statements.

ABC Co., Inc.

**Statement of Retained Earnings – Income Tax Basis
As of December 31, 20XX**

Retained Earnings at December 31, 20XX	\$ 11,097.11
Ordinary income	<u>15,099.39</u>
Retained Earnings at December 31, 20XX	<u><u>\$ 26,196.50</u></u>

See Accountant's Report and Notes to the Financial Statements.

ABC Co., Inc.

**Income Reconciliation Statement – Income Tax Basis
For the Year Ended December 31, 20XX**

Net Income Per Books	\$ 15,099.39
Expenses recorded on books not on the tax return:	
Entertainment Expense (50%)	<u>80.00</u>
Total	15,179.39
Taxable Income Per Corporate Tax Return	<u><u>\$ 15,179.39</u></u>

See Accountant's Report and Notes to the Financial Statements.

ABC Co., Inc.

**Statement of Cash Flows – Income Tax Basis
For the 12 Month Period Ending December 31, 20XX**

Cash flows from operating activities	
Net Income	\$ 15,099.39
Adjustments to reconcile net income to net cash provided by operations:	
Depreciation expense	4,387.21
Amortization expense	22,551.00
Increase in inventory	(2,012.20)
Decrease in account receivable	10,064.10
Increase in accounts payable	255.10
Increase in other payables	1,065.23
	<hr/>
Net cash provided by operating activities	36,310.44
Cash flows from investing activities:	
Short-term loan issued	(2,500.35)
Purchase of furniture & improvements	(2,684.21)
	<hr/>
Net cash used by investing activities	(5,184.56)
Cash flows from financing activities:	
Payment of debt	(23,350.13)
	<hr/>
Net cash used by financing activities	(23,350.13)
Net increase in cash	7,775.75
Cash at beginning of the year	6,625.63
	<hr/>
Cash at end of the year	\$ 14,401.38
	<hr/> <hr/>

See Accountant's Report and Notes to the Financial Statements.

ABC Co., Inc.

Notes To The Financial Statements As of December 31, 20XX

Note 1: Company operations: This company is a retail tobacco store located in Anywhere, Oklahoma.

Note 2: Summary of significant accounting policies:

Cash: Cash consists of demand deposits with banks.

Accounts Receivable: Minor, occasional business is done in wholesale trade. This figure represents monies due from other merchants and is generally received in less than 30 days.

Depreciation, Amortization, and Goodwill Valuation: Property, plant & equipment are valued at historical cost and depreciated by MACRS method as prescribed by the Internal Revenue Code. Furniture, fixtures and equipment are depreciated over periods between 3 to 7 years. Commercial buildings are depreciated over 39.5 years. Organization cost and goodwill are amortized over 5 and 15 years, respectively, using the straight-line method as prescribed by the Internal Revenue Code.

The company has elected to treat some assets under Internal Revenue Code Section 179, which allows the direct write-off of qualified assets in the first year of acquisition. This amount for year ending December 31, 20XX was \$1,784.21.

The company has also elected to take the allowable bonus depreciation. This bonus depreciation allows for an additional 30% of the depreciable basis to be depreciated in the first year. This allowed for an additional \$376.00 of depreciation.

Note 3: Inventories

The inventory value was determined by the First-in, First-out (FIFO) method. The inventory pricing method used is the lower of cost or market.

Note 4: Long-Term Debt

At December 31, 20XX the company's long-term debt was \$450,304.59. The debt for 20XX was at an average interest rate of 8.5%. The majority of the debt is a \$390,272.81 SBA loan with Bank of N/A at prime plus 2%. The loan is being repaid monthly, with the final payment due in 2016.

Note 5: Common Stock

The company's Articles of Incorporation authorize 500 shares of \$1.00 par value common stock. All 500 shares are issued and outstanding. The stock is held by two individuals John Doe (50%) and Richard Doe (50%).

ABC Co., Inc.

Notes To The Financial Statements As of December 31, 20XX

Note 6: Entity Structure

The corporation was incorporated on October 1, 1999 in the State of Oklahoma. As of the balance sheet date, the Oklahoma Secretary of State reports that the business is in good standing having filed all of its required franchise tax returns to date.

Note 7: Related Party Transactions

The company has a short-term loan receivable in the amount of \$3,223.77 from DEF Co., Inc. DEF Co., Inc., is also owned by the two stockholders of ABC, Inc. The loan is due March 31, 20XX in the amount of \$3,223.77 plus 6.5% interest.

Note 8: Collateralization of Liabilities

All of the company assets are collateral for the SBA loan (see Note 4) from Bank of N/A. The remainder of the long-term debt is unsecured.

Note 9: Officer/Stockholder Life Insurance

The corporation was required by SBA to acquire life insurance policies in the amount of \$50,000 each for the two stockholders. As set forth by the Internal Revenue Code, the cost of the premiums is included in insurance expense.

Appendix G

Sample Cash Basis Financial Statements – No Disclosure

**XYZ Accounting & Tax Service, Inc.
3600 E. Street, Somewhere, Ok 73000**

Dave Smith, President
ABC Welding Co., Inc.
526 W. Main
Anywhere, OK 73333

**—EXAMPLE NOT INCLUDED—
CONTENT MUST BE IN CONFORMANCE WITH
REQUIREMENTS OF YOUR STATE**

April 24, 20XX

XYZ Accounting & Tax Service, Inc.

ABC Welding Co., Inc.

**Balance Sheet – Income Tax Basis
As of December 31, 20XX**

Current Assets:

Cash	\$117,284.24
Loan – Short Term	<u>3,223.77</u>

Total Current Assets **120,508.01**

Fixed Assets:

Buildings & Other Depreciable Assets	92,011.31
Accumulated Depreciation	(18,858.20)
Land	<u>30,000.00</u>

Total Fixed Assets **103,153.11**

Other Assets:

Organization Cost	50.00
Accumulated Amortization	(43.72)
Goodwill	338,110.00
Accumulated Amortization	(73,248.00)
Deposits	555.00
Cash Bond	<u>500.00</u>

Total Other Assets **265,923.28**

Total Assets **\$489,584.40**

See Accountant's Report.

ABC Welding Co., Inc.

**Balance Sheet – Income Tax Basis
As of December 31, 20XX**

Current Liabilities:

Payroll Taxes Payable	\$ 1,402.23
Sales Tax Payable	7,081.08
Loans – Bank	<u>50,000.00</u>

Total Current Liabilities **58,483.31**

Long Term Liabilities:

Loans – Bank - In More Than 1 year	<u>400,304.59</u>
------------------------------------	-------------------

Total Long Term Liabilities **400,304.59**

Total Liabilities **458,787.90**

Stockholders' Equity:

Capital Stock	\$ 500.00
Retained Earnings	<u>30,296.50</u>

Total Stockholders' Equity **30,796.50**

Total Liabilities & Equity **\$489,584.40**

See Accountant's Report.

ABC Welding Co., Inc.

**Statement of Revenues and Expenses – Income Tax Basis
For the 12 Month Period Ending December 31, 20XX**

Sales	\$2,291,940.07
Cost of Operations:	
Steel purchases for custom work	<u>2,112,497.97</u>
Gross Profit	<u>179,442.10</u>
Expenses:	
Alarm	240.00
Amortization Expense	22,551.00
Bank Fees	2,703.25
Cash Shortage	1,673.51
Depreciation	4,387.21
Dues & Publications	95.00
Entertainment	161.23
Flowers & Gifts	522.35
Insurance	6,830.73
Interest	37,246.21
Licenses & Permits	80.00
Mileage Paid	4,384.99
Office Supplies	112.81
Payroll – Employees	44,792.77
Payroll – Officer	14,958.28
Payroll Taxes	4,912.88
Postage	77.65
Repair & Maintenance	2,444.25
Returned Checks	4,103.89
Taxes – Other	69.28
Taxes – Property	1,210.87
Telephone	1,330.08
Travel Expense	194.08
Utilities	<u>5,160.39</u>
Total Expenses	<u>160,242.71</u>
Net Income	<u><u>\$ 19,199.39</u></u>

See Accountant's Report.

Appendix H

Additional Recommended Reference Materials

The National Society of Accountants recommends that all accountants maintain *current versions* of the following reference materials in their office library.

- Internal Revenue Code
- Internal Revenue Code Regulations and other documents issued by the IRS
- Court Cases
- Tax research library service with interpretations
- Statements of Financial Accounting Standards and other pronouncements issued by the Financial Accounting Standards Board (FASB) – refer to www.fasb.org.

Knowledge of the principles contained in the following publications is necessary for a better understanding and interpretation of existing accounting theory and application. While some of the material is better suited for publicly traded entities, there are overlapping areas of commonality in basic, underlying theory and presentation, stretching from the very first example of the classified Balance Sheet produced by the Federal Reserve Board in the early 1920s through the present. Practitioners should check frequently throughout the year to ensure that they have the most current versions of the following in their reference library or available to them online. This list is not all-inclusive and similar information may be obtained in other publications.

- Practitioner’s Guide to GAAS 20XX, Dan M. Guy, D. R. Carmichael, Linda A. Lach, John Wiley & Sons, Inc.
- PPC’s Guide to Cash, Tax and Other Bases of Accounting, Volumes 1 and 2 – XX Edition. (ppc.thomson.com)
- XX Edition, Accountant’s Handbook, D. R. Carmichael, Paul H. Rosenfield, John Wiley & Sons, Inc.
- GAAP 20XX, Patrick R. Delaney, Ralph Nach, Barry J. Epstein, Susan Weiss Budak, John Wiley & Sons, Inc.
- 20XX Miller GAAP Guide, Jan R. Williams, Joseph V. Carcello, Aspen Publishers.
- Also, any good intermediate accounting text book for college-level courses.