

# [Gaap verses other bases essay](https://assignbuster.com/gaap-verses-other-bases-essay/)

## Introduction

“ Other Comprehensive Basis of Accounting” (OCBOA) is a term that is used to refer to bases of accounting other that the Generally Accepted Accounting Principles (GAAP). They are defined under the SAS no. 62, special Reports, as comprising of a statutory basis of accounting, income -tax-basis financial statements, cash-basis and the modified-cash-basis financial statements as well as financial statements that are prepared using definitive criteria that has substantial support in the accounting literature which the preparer applies to all the material items that appear in the statements, for instance, price level basis of accounting. The cash-basis (modified-cash-basis include) and the tax-basis financial statements are the most widely used of the OCBOA statements. This excerpt will as such focus on these two types of financial statements by comparing them to the GAAP financial statements as well as determine when and who uses them as well as any hindrances and advantages that are accrued from their use.

GAAP vs. Common bases of accounting

Financial statements which are prepared by utilizing other comprehensive bases of accounting (OCBOA) are becoming increasingly popular. They are more popular with smaller, nonpublic entities which feel over burdened by the reporting and accounting guidance issued under the Generally Accepted Accounting Practices as well as feel that the cist of adhering to those stringent reporting and accounting guidance exceed the related benefits. Most of these entities as such chose to prepare OCBOA financial statements under appropriate circumstances (McEachern 2005).

Currently, technical guidance related to reporting issues for the OCBOA financial statements is very minimal. The main reason for this “ lack” in guidance is because accounting literature usually relates to the GAAP-based financial statement as opposed to those which are no-GAAP based. In addition, there is no standard-setting organization for the OCBOAs as is the case with the GAAP. Practitioners as such usually interpret the audit guidance provide in the AU 623 when preparing the OCBOA financial statements. The practitioners’ judgment regarding the entire financial statements presentation should be applied within a framework that is identifiable.

OCBOAs that are recognized under the AU 623. 04 include: the basis of accounting under use by a reporting entity in order to comply with the financial reporting provisions or requirement of the governmental regulatory agency that has jurisdiction over that entity; the basis of accounting the reporting entity expects to use or used to file income tax return for the period that is covered by the financial statements; the cash disbursements and receipts basis of accounting as well as cash-basis modifications that have substantial support, for instance, accruing income taxes or recording depreciation on the entity’s fixed assets. A set of criteria that is definite and has substantial support applied to all materials that appear in the financial statements, such as the price-level basis of accounting (McEachern 2005).

OCBOA financials statements present an alternative to the use of the statements that are GAAP based. The main reason for use of such financial statement is because they are typically cheaper. The tax-basis financial statements usually contributes to cost cutting because the financial statements as well as the tax returns are prepared by using the same information. The cash-basis statements are cheaper since the details that are required in order to comply with the GAAP reporting standards are not necessary. The biggest challenge in using such financial statements is the determination of their appropriateness with regard to the entity’s nature. Characteristics of the entities which can consider the issuing of tax-basis or cash-basis financial statements are identifies in the AICPA PAS document (Ratcliffe 2003).

The cost saving associated with OCBOA statements is primarily derived from the use of simpler measurement principals, for instance, modified cash and cash-basis statements, or the use of measurement principles that are already incorporated into other document, for instance, a tax return, in the preparation of the financial statements. Cost savings derived from disclosure requirements is limited since both the GAAP-based statements and the OCBOA-based statements are subject to parallel disclosure requirements. Disclosure requirements for practitioners issuing OCBOA financial statements are provided for in the issuance of the Auditing Interpretation No. 14. This interpretation provides for greater disclosure advantage in th issuance of OCBOA financial statements than it was possible previously (Ratcliffe 2003).

Though the OCBOA financial statement may be subject to compilation, review or auditing, the disclosure requirements are essentially similar. The SAS No. 62 disclosure requirements for OCBOA financial statements that are audited are similar to those for reviewed (or compiled) OCBOA financial statements. Practitioners are still however required to have an understanding of the disclosure requirements under the GAAP so as to ensure that the OCBOA financial statements are in compliance with financial reporting requirements, for example the disclosure made should be able to communicate the GAAP disclosures’ substance (Ratcliffe 2003).

According to practitioners, the OCBOA statements become simpler when they do not include all the items, transactions and events that are typically part of the GAAP statements. For instance, deferred taxes are not shown in tax-basis statements, as such the tax disclosures required by GAAP-basis statements are not included. However, there is usually no disclosure ‘ advantage for practitioner when they have reviewed or compiled OCBOA statements vs. when auditing them. The advantage is ass a result of using another basis of accounting for the financial statements’ preparations and not from the level of service (compilation, review or audit) that is provided (Ratcliffe 2003).

Third-party users have been known to create roadblocks to the use of OCBOA method. In such cases, providing additional information that is outside the basic financial statement provided is one way of inclining the third-parties to accepting the OCBOA financial statement. For instance, in a situation where a partnership has borrowed under a line of credit whereby the lending limit is established on the basis of the partnership’s accounts receivable level, the lender might accept tax-basis financials statements as opposed to statements that are GAAP-based provided the partnership provides a receivables list from aged accounts too (Grice 2003).

Pure cash basis

Under the pure cash basis of accounting (disbursements and receipts), only those transactions that increase the entity’s cash and cash equivalent appear in the financial disbursements. The cash disbursements are recognized as expenses while the cash receipts are revenue. This basis is rare in practice. Companies that are known to use this basis of accounting have characteristic such as: not profit-oriented; simple operations, unsophisticated finance and accounting functions; only one major activity; and insignificant long-term debt and capital expenditures. These include such entities such as civic ventures, school activity funds, political action committees, trusts and estates and political campaigns (Grice 2003).

Modified cash basis

This basis of accounting is the pure cash-basis with incorporate modification which has substantial support. These modifications include the recognition of transactions on an accrual basis similar to the way an entity would recognize them under the GAAP. However, the literature does not define clearly the appropriate modification or the extent of such modifications. Thus basis f accounting is usually applied by entities which are profit-oriented; distribute the profits as collected, for instance, through retirement plan contributions and bonuses; have significant credit and inventory arrangements with vendors; incur dent on material amounts or make expenditures on material capital; and have somewhat sophisticated operations and complex accounting procedures. These entities include professional associations such as lawyers, doctors and CPAs (Grice 2003).

Income Tax Basis

Income tax-based accounting is based on the federal laws on income tax. However, these laws do not usually address the financial statement disclosure or presentation considerations. Companies that use this basis of accounting are generally enterprises that are profit-oriented (small closely-held companies that might find the conversion to GAAP costly); partnerships which have a requirement under the partnership agreements to use the tax-based accounting method. Not-for-profit originations that are seeking relied from the requirements of the FAS-116 and the FAS-117 (Grice 2003).

Appropriate use of OCBOA financial statements

Before determining whether to use an OCBOA, the practitioner considers several issues. Where an entity keeps inventory, the pure cash-based accounting is not appropriate. The basis of accounting used by the entity to prepare its income tax is another consideration whereby one should use the same basis of accounting for both. Where entities are highly leveraged, the lenders may require the use of GAAP financial statements. Where outside investors are present, the information that is required is usually provided by GAAP financial statements. Where an entity has a cash flow parallel to its income and expenditure the pure cash basis is most appropriate. Where the entity anticipates going public, it will require a history of GAAP financial statements. Where an entity is formed for tax purpose the owner is most likely interested on the effects of tax on transactions and as such the income tax basis is most appropriate. In addition, where entities are subject to bonding requirements, then the GAAP financial statements are the only ones accepted (Madray 2006).

Any entity that is not nor required either by a contract or otherwise to prepare GAAP financial statements can issue OCBOA financial statements. Several conditions should however be met when an entity decides to use them. The external as well as internal users of the financial statements should understand the presentation of the OCBOA and find it relevant to the needs they have. The preparation of the OCBOA financial statements is cost-effective. In addition, the entity’s operations are conducive for the presentation of the OCBOA (Madray 2006).

The AICPA provides a non-authoritative practice aid that gives considerations and characteristics for entities that wish to issue tax- and cash-bass financial statements. When considering third-parties user needs, this includes: those entities that do not have third-part users of their financial statements, such as small closely-held companies that do not have third-party debt; entity’s whose debt is secured as opposed to unsecured; and the provision of GAAP financial statements is not required by the entity’s creditors. When considering the user needs of managers and owners: the entity’s owners and managers should be involved in the day-to-day running of the business and have a picture of the financial position of the entity which is fairly clear; the primary interest of the owners is cash flows, for instance, professional corporation of lawyers which distributes it cash-basis earnings through retirement plan contributions, bonuses and salaries; where the primary interest of the owners is the implication of tax on transactions. Another area is const effectiveness where the cost incurred by the entity to comply with GAAP would exceed the benefits. The entity should also not be subject to rules by the Internal Revenue Code to prepare the tax returns n the basis of the accrual accounting method. Under operations considerations long term financing and capital expenditure should not be significant to the entity.

The issuance of OCBOA is mostly determined by the needs of the users of the financial statement. This financial statements should however not be provided if the results of doing so will be misleading. Several guidelines exist to ensure this does not happen. Practitioners are essentially expected to prepare OCBOA financial statements while applying the same criteria on the OCBOA as they would on the GAAP-conforming financial statements. As such, the opinion of the practioner should be based on judgment regarding whether the OCBOA financial statement including the notes related to it, are informative in the way they address the way they are used, interpreted and understood (Madray 2006).

Accountants usually consider the OCBOA as misleading and inappropriate under certain conditions. For instance, where an entity has substantial unfunded commitments, obligations and contingent liabilities, they would not appear on the tax or cash-based financial statement and as such not give a clear financial picture of that entity. The cash-basis also does not show where an entity has delayed paying its current liabilities such as accounts basis. In additional, where the financial statements compiled omit the inclusion of all substantial disclosures (Madray 2006).

Conclusion

The use of OCBOA financial statements is becoming increasingly popular. Practitioners continue to look for logical alternatives to the financial statements preparation and reporting of financial statements as GAAP-basis statements continue being subject to growing complexity of the accounting guidance. OCBOA financial statements provide an option that is more understandable as well as cost-beneficial for the clients. As the regulatory landscape continue to change, for instance, enhancements made to the requirements of GAAP reporting, it is clear that the OCBOA statements will become even more popular with financial statements’ users and preparers.