Accounting & Audit Advisor

OCBOA financial statements: a refresher

By CPAmerica A&A Technical Consultant Thomas A. Ratcliffe, Ph.D., CPA

With the increasing complexity of addressing accounting and reporting matters to comply with accounting principles generally accepted in the United States (U.S. GAAP), many financial statement preparers often look for less complicated, less time-consuming and less costly alternatives for their financial reporting needs.

When acceptable from the perspective of financial statement users, one widely used alternative is to prepare financial statements using an "other comprehensive basis of accounting" (OCBOA).

Since tax basis and cash basis – including modifications to the cash basis – financial statements are the most widely used OCBOA statements, the remaining guidance focuses on significant issues associated with preparing and reporting on financial statements using those bases.

Some practical reminders

In addressing the preparation and reporting of OCBOA financial statements over the years, the following are some of the issues that need to be understood:

- OCBOA statements can be audited, reviewed or compiled.
- They are simpler and more cost-effective to prepare.
- Disclosures in OCBOA statements need to either parallel disclosures in U.S. GAAP-based statements or communicate the substance of disclosures that would have been included in the U.S. GAAP-based statements.
- OCBOA statements should include a policy note describing the other comprehensive basis of accounting and clearly delineating the primary substantive differences between the OCBOA and U.S. GAAP.
- There is no difference in disclosure requirements between audited financial statements and those that are reviewed or compiled.
- In modifying cash-based statements, preparers need to exercise care not to go so far with the modifications as to have the statements essentially prepared on a U.S. GAAP basis with departures from that basis of accounting.
- OCBOA financial statement titles need to be modified to clearly indicate the basis of accounting used in the statements.
- A statement of cash flows is not required in OCBOA financial statements.

Answers to frequently asked questions

Following are some of the issues in which questions have risen to the forefront in the recent past:

Q. Do fair value measurement and disclosure requirements in U.S. GAAP need to be incorporated into OCBOA statements?

A. No. Financial statements prepared on a tax basis incorporate measurements into the statements paralleling measurements included in the tax returns. Cash basis statements include measurements based on cash receipts and disbursements.

Q. Do the uncertain tax positions measurement and disclosure requirements in U.S. GAAP need to be incorporated into OCBOA statements?

See **OCBOA** *on page 4*

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Decode financial statements to benefit your business

By Guest Columnist Janet Holland, CPA, with DZH Phillips LLP, a CPAmerica International member firm

In any business, chief executives often focus on the product or service being offered and rely on others to manage the finances. Bank balances, receipts and payments are easily understood, but things like accrual basis accounting, ratios and working capital can be confusing to nonaccountants.

Certain financial statement indicators can alert management to potential issues that need to be addressed:

- Ongoing losses
- Aged and possibly uncollectible receivables
- Slow-moving or obsolete inventory
- A reduction in gross profit as a percentage of sales
- Liabilities that exceed assets
- Increased overhead
- Loan covenant violations
- The need to refinance long-term debt or obtain additional sources of financing

To have a complete picture of the company's financial situation, accrual-basis financial statements are necessary – unless the company does not have significant receivables or payables.

Full accrual financial statements include the following as assets:

- Accounts receivable from customers
- Payments for future periods, such as rent or insurance
- Inventory purchased but not yet sold

Accrual-basis liabilities include:

- Accounts payable to vendors
- Accruals for unpaid vacation and wages
- Unpaid interest on debt
- Payments for goods or services not yet provided (deferred revenue)
- Retirement plan contributions owed but not yet paid

Essentially, accrual-basis financial statements provide a more complete picture of financial position than the amount of cash in the bank at any given time.

At a minimum, the two basic accrual-basis financial statements that should be reviewed monthly are the balance sheet and the income statement.

- The balance sheet effectively shows what the company owns and what it owes at a point in time, with the difference being the owners' equity in the company.
- The income statement shows operating results for a period of time, broken down by revenue line items and expense line items.

In reviewing the financial statements, management should first ensure that the accounts have been properly reconciled and adjusted so that the information is reliable.

The balance sheet should be classified, separating current assets and liabilities from long-term assets and liabilities. Current amounts include anything that is expected to be converted into cash within a year.

In reviewing the balance sheet, items to consider include:

- Whether all receivables are collectible
- Whether the value of inventory is overstated due to obsolescence
- Whether all amounts owed are reflected as liabilities

Working capital should be calculated, defined as the excess of current assets over current liabilities. It is a measure of whether the company has the means to pay obligations as they come due. Negative working capital is an indicator of financial problems.

Working capital can be expressed as a ratio of current assets to current liabilities and can be calculated over time to highlight negative trends that should be addressed. Seasonality may also affect working capital and the need to draw down on a line of credit.

There are industry-specific ratios, such as accounts receivable turnover, inventory turnover and debt to equity that should be calculated if meaningful to the company. Some ratios may need to be monitored as part of loan covenants. In addition, consideration should be given to whether there are enough reserves to prevent deferred maintenance or whether there is insufficient investment back into the company.

In reviewing the income statement, the obvious first consideration is net income – the excess of revenues over expenses. Losses – the excess of expenses over revenue – should be addressed to mitigate long-term negative effects on the company.

There should also be a comparison of budgeted or expected operating results to actual, for both the current period and year to date, with explanations for deviations from expectations.

The balance sheet and the income statement are interrelated. Assets are typically increased by profits, and liabilities are typically decreased. Net income directly increases equity in the company, while losses reduce equity.

See ***Decoding financial statements*** *on page 3*

Three methods to account for treasury stock transactions

By CPAmerica A&A Technical Consultant Thomas A. Ratcliffe, Ph.D., CPA

The accounting and financial reporting guidance addressing treasury stock transactions isn't anything new. But preparers of financial statements raise questions when addressing measurement and disclosure requirements associated with these transactions.

Questions arise about how the preparers should consider the authoritative accounting technical literature and various state laws and regulations so that financial statements are prepared properly.

The authoritative technical literature addressing accounting issues related to treasury stock transactions is in the Financial Accounting Standards Board's Accounting Standards Codification Topic 505-30, *Treasury Stock*.

In complying with the accounting technical literature, the reacquisition of shares, any subsequent resale of the shares and any ultimate retirement of the shares depend on the method used in initially reflecting treasury stock transactions in financial statements. Practically, these transactions are reflected in financial statements through use of the cost method, the par value method or the constructive retirement method.

1

The cost method. In using the cost method of accounting for treasury stock transactions, the aggregate cost of shares reacquired is charged to a contra-equity account referred to as treasury stock. Essentially, equity accounts that initially were established upon issuance of the shares remain unchanged.

If the shares subsequently are reissued, any proceeds received that are greater than the reacquisition cost are credited to paid-in capital. Any deficiency associated with a reissuance is charged to retained earnings, unless paid-in capital from previous treasury stock transactions exists. In that case, the deficiency would be charged to paid-in capital first before being charged to retained earnings.

The cost method frequently is used in practice when reporting entities reacquire their own shares for reasons other than retiring the shares. The method also is popular in practice when reporting entity management has not made decisions as to whether the reacquired shares will be retired, held indefinitely or reissued.

2

The par value method. In using the par value method of accounting for treasury stock transactions, the treasury stock account is charged only for the aggregate par, or stated, value of the reacquired shares.

Then, it is important to consider amounts of additional paid-in capital available to absorb any difference between the reacquisition price and the par value of the reacquired shares. To the extent that sufficient paid-in capital is not available to absorb the difference, retained earnings would be charged for the remaining amount.

3

The constructive retirement method. In using the constructive retirement method of accounting for treasury stock transactions, financial statement preparers will notice similarities to using the par value method.

The obvious difference between the two methods relates to the initial recording of reacquired treasury shares because the treasury stock account is not used. Rather, as the name of the method implies, the journal entries are assembled in a manner similar to how they would be used if the shares actually were being retired upon reacquisition.

When reporting entities are incorporated in states where laws define reacquisition of shares to be retirement of the shares, the constructive retirement method actually is the only one of the three methods that would be consistent with the laws. In fact, in certain jurisdictions, reporting entities are required to use the constructive retirement method in accounting for treasury stock transactions.

Decoding financial statements *continued from page 2*

The final financial statement that may be useful is the statement of cash flows. It basically consists of three parts:

- Operating activities – cash inflows and outflows from operating the business
- Investing activities – cash inflows and outflows from buying and selling fixed assets, purchasing or selling investments or making loans
- Financing activities – cash inflows and outflows from loan proceeds, repayment of debt principal, capital contributions and distributions to owners

The financial statement can be misleading if not considered in conjunction with the balance sheet and income statement. The reason is that, when additional cash is collected or a payment is made, the financial statement can change significantly.

Other considerations in reviewing the financial results of a company include:

- Comparing operating results to industry benchmarks
- Trending operating results over a period of five years
- Modeling financial scenarios to plan for the future

These analyses help to stop negative trends that a company can address before it's too late. They can help to modify or cut unprofitable segments of the business and to manage cash flow. When necessary, the company can also use the analyses to determine financing needs. ▮

OCBOA *continued from page 1*

A. To some extent. Financial statements prepared on a tax basis or a cash basis certainly do not incorporate the uncertain tax position recognition and measurement guidance that would be used in preparing statements using U.S. GAAP.

With that said, given that uncertainties need to be disclosed in OCBOA statements in a manner similar to how they are disclosed in statements prepared using U.S. GAAP, any interest and penalties associated with income taxes do need to be disclosed. In addition, open tax years need to be disclosed in *all* financial statements without regard to the basis of accounting used in preparing the statements.

Q. Do the consolidation of variable interest entities requirements in U.S. GAAP need to be incorporated into OCBOA statements?

A. No. Financial statements prepared on a tax basis incorporate the consolidation of affiliated entities based on the provisions of income tax laws and regulations. And, there is no need to address the consolidation of variable interest entities in cash basis statements.

Essentially, some of the more challenging requirements associated with reporting entities needing to consolidate variable interest entities do not need to be considered when financial statements are prepared using an OCBOA.

Q. Do the disclosure requirements associated with management evaluating subsequent events in U.S. GAAP need to be incorporated into OCBOA statements?

A. Yes. Disclosure requirements associated with subsequent events are the same without regard to whether financial statements are prepared using U.S. GAAP or either the income tax basis or the cash basis of accounting, including modifications to the cash basis of accounting. Essentially, from a disclosure perspective, there is no difference in how subsequent events issues should be addressed.

Q. When compiled financial statements exist from which management elects to omit substantially all disclosures, should the date through which management evaluates subsequent events be in the practitioner compilation reports?

A. No. This is another issue in which the basis of accounting is irrelevant. When practitioners compile financial statements from which management elects to omit substantially all disclosures, practitioners are *precluded* from including the date through which management evaluates subsequent events in their compilation reports. If they include the date, practitioners would introduce information into the financial statements that is not included in the financial statements themselves. ▮

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