How to Choose Between GAAP and Tax Basis Reporting: Step by Step Breakdown

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In financial reporting, not all businesses follow the same rules. There are two main approaches, which are GAAP and tax basis reporting.

So, GAAP, or Generally Accepted Accounting Principles, is the standard in the US. It's used by public companies and often required by lenders and investors. GAAP relies heavily on accrual accounting, meaning income and expenses are recorded when they're earned or incurred.

Tax basis reporting follows IRS rules, and especially for smaller businesses, it focuses on actual cash transactions. So, revenue is recorded when cash is received, and expenses are recorded when they're paid. This method is often simpler and less expensive to maintain, which is why most private businesses prefer it, if they can. Larger private businesses may be required to use an accrual method of accounting for tax purposes as well, although there are still different rules for tax versus GAAP under the accrual concepts.

One area of accrual method differences is the treatment of estimates or allowances, such as bad debts or inventory obsolescence. GAAP recognizes these in anticipation of a future write-off, using estimates based on the likelihood or historical rate of occurrence, and on the other hand, tax basis reporting waits until the losses are actually realized and clearly measurable.

As a general rule for estimates and allowances, tax basis methods lead to an earlier recognition of income and a later recognition of deductions. And GAAP is usually the opposite.

Under either the cash or accrual methods, asset depreciation is also handled differently between GAAP and tax. For example, consider a large purchase of business equipment. GAAP will aim to spread the write-off of that cost evenly over the asset's useful life, whereas tax rules favor quicker methods that heavily load the deductions towards the year that the asset is purchased and placed in service and tax may also have a much shorter useful life than what we'd use for GAAP.

So which method is right for your business? For non-publicly traded companies, GAAP is ideal if you're raising capital or dealing with investors, whether that's right now or maybe in the next few years. Tax-basis can work well for smaller companies focused on simplicity and alignment with their tax filings.

Ultimately, your choice should reflect your business's goals and needs. If you're incurring the costs of a more complex system of accounting, you should be sure that you're actually in a position to get the benefits of using it. And consulting with your CPA will help you select the best path for your business, with that cost benefit analysis in mind.

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