



AICPA Issues Optional Framework for Small- and Medium-Sized Entities

By John Cronin, CPA

The American Institute of Certified Public Accountants ("AICPA") has issued a special-purpose reporting framework that is attracting the interest of smaller private businesses. The reporting framework is called the "Financial Reporting Framework for Small- and Medium-Sized Entities" ("FRF for SMEs"). Although its title sounds very similar to International Financial Reporting Standards ("IFRS") for SMEs, there are important differences. Most notably, IFRS for SMEs is recognized as a set of generally accepted accounting principles, but the AICPA's framework is not. Since the AICPA lacks the authority to require its framework, any use of it is strictly optional. This article describes the reporting framework and provides insights into the next steps.

Overview of the AICPA's Framework

The AICPA's framework is intended as a less-complicated, lower-cost alternative basis of accounting for entities that are not required to provide U.S. Generally Accepted Accounting Principles ("GAAP")-based financial statements. When the AICPA proposed the framework, it received many questions about the applicability and reliability of a non-authoritative special reporting framework. The final version contains answers to some of the questions raised, including the following:

1. **Applicability.** Some accountants expressed concern that there are no clear restrictions on the use of FRF for SMEs. In response, the AICPA has provided a list of characteristics of "typical" entities that may prefer to use the FRF for SMEs rather than GAAP for their financial reports.

In a typical use of the framework:

- a. The reporting entity would be a simple for-profit organization whose owners and managers intend for it to stay private, rather than go public through an initial public offering.
- b. The individuals who own a controlling interest in the entity should also run the company.
- c. The reporting entity would not need to:
 - i. Comply with regulations requiring financial statements prepared in accordance with GAAP.
 - ii. Have overly complicated transactions or significant foreign operations.
 - iii. Would not operate in an industry (such as financial services) that typically engages in transactions that require highly specialized accounting guidance.
- d. *The users* of the entity's financial statements typically would be its management and owners. These users would rely on the statements mostly to confirm their assessments of performance, cash flows, and what they own and owe. Any external users would have direct access to the entity's management, and their interest in the financial statements would relate

mainly to such matters as cash flows, liquidity, statement of financial position strength, and interest coverage. For example, financial statements prepared using FRF for SMEs might support applications for bank financing when the banker does not base a lending decision solely on the financial statements.

2. **Reliability.** The AICPA also heard concerns that the framework is not sufficiently robust and permits too many options, too few disclosures, and too much judgment for consistent reliable reporting. In response, the final version provides a preface that explains the framework is a principles-based approach that encourages the use of professional judgment and provides management with a suitable degree of optionality when choosing accounting policies. To achieve this purpose, the framework intentionally "...eschews prescriptive, detailed standards and voluminous disclosure requirements."

Examples of the principles used in the FRF for SMEs framework and the places where they depart from (or are less prescriptive than) GAAP are summarized below.

- a. The FRF for SMEs framework does not include sections on earnings per share, segment reporting, other comprehensive income, interim reporting, and stock-based compensation.
- b. The FRF for SMEs framework moves away from the use of fair value and relies primarily on historical cost as the measurement basis.
- c. The FRF for SMEs framework does not use the concept of variable interest entities as criteria for consolidation of other entities. Instead, an entity may make an accounting policy election to either consolidate its subsidiaries or use the equity method to account for them.
- d. Derivatives are disclosed but are not recognized until settlement (based on the net cash paid or received).
- e. The accounting for leases is closely aligned with the requirements of the Internal Revenue Code for US federal income taxes.
- f. The framework does not require testing of goodwill for impairment. Instead, goodwill is amortized over the same period used for US federal income tax purposes or over 15 years. All other intangible assets are viewed as having a definite life over which they are amortized.
- g. In cases where the FRF for SMEs framework does not specifically address a transaction, event or condition, the AICPA's framework suggests, "...management should use its judgment and apply the general principles, concepts, and criteria contained in the framework when developing accounting policies."

Insights and Next Steps

Although the FRF for SMEs framework is available for use now, the AICPA and other influential organizations are still issuing additional materials to help small businesses come to grips with the pros and cons of the FRF for SMEs compared with GAAP. Below is a summary of recent developments and key sources of information.

1. **NASBA.** The National Association of State Boards of Accountancy ("NASBA") is the national organization for the 55 US boards of accountancy (the "Boards"). NASBA has issued several releases on the FRF for SMEs. The first, issued in June 2013, contains a strongly-worded statement that reaffirms its support for GAAP and cites its opposition to non-authoritative frameworks. Currently, the boards accept the audit, compilation and review standards issued by the AICPA for non-public companies. However, NASBA's press release cautioned that exceptions could be made for the FRF for SMEs and private companies should not consider adopting the framework until more guidance is available. In a subsequent press release issued jointly with the AICPA, NASBA said that an entity's decision to use the FRF for SMEs should be based on its individual facts and circumstances. This release indicates NASBA plans to work

with the AICPA to develop additional guidance. Together, the releases indicate that NASBA's upcoming communications will include the following:

- a. NASBA will be providing the Boards with information and guidance to address the use of non-authoritative reporting frameworks. This may include communication to all CPAs and CPA firms that they should consider the risks of using or recommending FRF for SMEs.
 - b. NASBA has formed a study group that includes state Board regulators from around the country, and it is developing recommended rule language prohibiting the use of non-authoritative standards unless they are acceptable to the Boards.
 - c. NASBA plans to work with the AICPA to develop: (a) a decision-making tool to help companies decide if FRF for SMEs is suitable, and (b) illustrative financial statements and disclosures to distinguish financial statements based on the FRF for SMEs from GAAP-based financial statements.
2. **IMA.** The Institute of Management Accountants ("IMA") has also voiced concerns about the use of an optional reporting framework. Unlike NASBA, IMA has not yet indicated its position might change based on upcoming guidance. Specifically, the IMA is concerned about the risk that an optional reporting framework would cause marketplace confusion that would be harmful to its members and their employers. In June 2013, the IMA issued a press release saying private company financial reporting should be based on GAAP. This release includes a cautionary statement warning that private companies need to maintain credibility, and businesses should not risk that credibility by adhering to a framework created by a group other than a recognized accounting standard-setting body.
3. **FASB.** The Private Company Council ("PCC") of the Financial Accounting Standards Board ("FASB") continues to make good progress in its efforts to modify GAAP to better accommodate the needs of private companies. Recent developments in the FASB's private-company reporting initiative include the following.
 - a. On the same day the AICPA released its framework, the FASB approved the issuance of several new proposals to modify GAAP for private companies on some of the same topics mentioned above. These proposals have now been exposed for public comment.
 - b. The PCC approved a new private company decision-making framework at its July 2013 meeting. It also agreed to expose for public comment a proposed alternative within GAAP for applying consolidation guidance for leasing entities under common control, and it persuaded the FASB to consider modifications for development stage companies.
 - c. The Financial Accounting Foundation, which is the body that oversees the work of the FASB and the Governmental Accounting Standards Board ("GASB") as the country's authoritative standard-setters, issued a statement underscoring the importance of clarity about the purpose and use of the FRF for SMEs framework. The statement says, "Everyone who has an interest in private company financial reporting – lenders, investors, and private company executives – needs to understand the significant and substantive differences between the two separate efforts now underway – one by the FASB, the other by the AICPA – to address the accounting concerns of private company stakeholders."
4. **AICPA.** In an attempt to address the need for additional guidance on the FRF for SMEs and how it differs from the GAAP, the AICPA is developing a variety of additional materials and forums to build awareness and understanding of the new framework and to explain some of the principles. Some materials are available now; others will be available shortly. The materials and forums include:

- a. A number of toolkits targeted toward small businesses, users of financial statements, and accounting firms of varying sizes. The toolkits contain information in various media, including videos, presentations, flyers, templates, and print. These materials include illustrative financial statements and comparisons of the principles used in its FRF for SMEs with those used in GAAP, IFRS for SMEs, and other financial reporting frameworks.
- b. An alert on "Understanding the Financial Reporting Framework for Small- and Medium-Sized Entities." The alert is intended mainly for use by accountants in businesses, financial statement users such as bankers, and smaller and regional accounting firms.
- c. An expansion of its Accounting and Auditing Technical Hotline, so that accountants who are members of the AICPA may contact the hotline with questions about the FRF for SMEs.

For More Information

If you have any specific questions regarding the reporting framework, please contact your CBIZ Tofias & Mayer Hoffman McCann advisor, or you may reach us at TheBottomLine@cbiztofias.com and 617.761.0600.

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